1031-B
Y4.Sm1:L78/4

IMPACT ON SMALL BUSINESS OF PROPOSED CUTS ON SBA GUARANTEED LOAN PROGRAM

COMPLETED ORIGINAL

HEARING

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., MARCH 31, 1982

Printed for the use of the Committee on Small Business

Y4.Sm1:L78/4

U.S. GOVERNMENT PRINTING OFFICE
97-261 O WASHINGTON: 1982

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IMPACT ON SMALL BUSINESS OF PROPOSED CUTS ON SBA GUARANTEED LOAN PROGRAM

WEDNESDAY, MARCH 31, 1982

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL OVERSIGHT,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LaFALCE

Mr. LAFALCE. The Subcommittee on General Oversight of the House Small Business Committee will come to order. Today, we open a series of hearings on the impact on small business of the Small Business Administration's budget and program cuts.

As we begin these hearings, our Nation's 15 million small businesses are experiencing the most serious problems since the Great Depression. These problems are discussed in great detail in a report President Reagan released earlier this month entitled "The State of Small Business." The President is to be commended for issuing a report that provides a wealth of information on the condition of small business. I have read it carefully and want to take a moment to review what it and other studies say about small business today. They find that:

Business failures compiled by Dun & Bradstreet are running at near depression levels. The President's report says total business failures have risen at least 30 percent during the past year.

Small business income has dropped 12 percent in the past 2 years.

Small businesses are paying 10 to 12 percentage points above the inflation rate on their bank loans, the highest interest rates since before World War II.

Small businesses are being crowded out of bank lending by large corporations. This is a primary finding of the President's report. The report warns that this hits small businesses especially hard because they rely almost exclusively on bank borrowing for capital.

The President's report makes clear that small business is being hit harder by the current recession than large business.

These findings have grave implications for small business and our economy. Over the last decade, we have come to rely on small business to create millions of new jobs, and to keep our economy productive and competitive. Prof. David Birch of MIT, a leading

student of job creation, tells us that "larger firms are no longer the major provider of new jobs to Americans." His studies show that almost 90 percent of the recent new employment in our economy has come from firms with 500 or fewer employees, and that firms with 20 or fewer employees have accounted for over two-thirds of the new jobs.

Moreover, small businesses have been at the cutting edge of innovation. The National Science Foundation's Science Indicators report for 1976 states that small business produces 24 times more innovation per R. & D. dollar than large firms and 4 times more than medium-sized firms.

Over this decade, at least 15 million new jobs will have to be created to employ our expanding adult population. That does not include the jobs needed to replace lost jobs and put our unemployed back to work. I am especially concerned about the creation of new jobs because of the chronically high unemployment rate in my own area of western New York. That unemployment rate, 14.3 percent, is now higher than at any time since the Great Depression.

Clearly, small business will be expected to provide many of these new jobs and to generate the innovations, the new technologies, and new companies essential to revitalizing our economy. I hope it can meet these expectations.

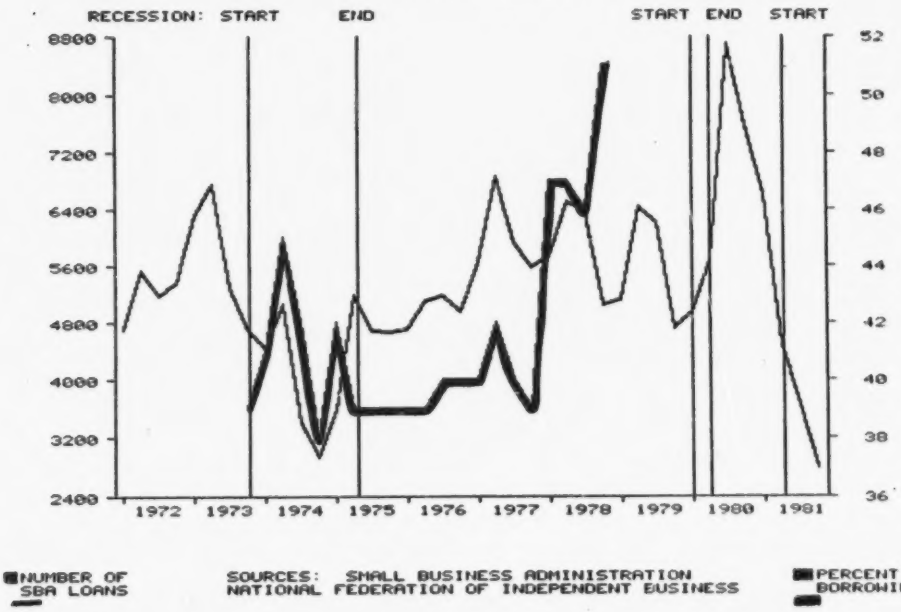
Today's hearing focuses on the Small Business Administration's guaranteed business loan program, and what role it plays in making capital available to small business in the current economic climate.

Since it began in 1954, the SBA guaranteed loan program has made almost 300,000 business loans totaling $26.9 billion. These loans have been used to start new small businesses, tide healthy small businesses over difficult times and create hundreds of thousands of new jobs.

Small businesses rely on these loans to help them cope with and recover from a recession. These loans are an essential ingredient of any recovery. I am placing in the hearing record a graph prepared at my direction that compares SBA guaranteed loan approvals and small business borrowing with the economic cycles. This graph demonstrates the demand and need for SBA guaranteed loans in both recession and recovery.

[The graph referred to above follows:]

COMPARISON OF SMALL BUSINESS BORROWING AND SBA GUARANTEED LENDING



Mr. LAFALCE. Over 10,000 banks participate in the SBA guaranteed business loan program and have found it an important mechanism for channeling much-needed lending money to small business.

The Small Business Administration has proposed cutting the guaranteed loan program deeply for the second year in a row. Under SBA's plans, the guaranteed loan program would be reduced to $2.4 billion in fiscal year 1983 from $3.3 billion in fiscal year 1982—a 27-percent reduction. As you recall, the guaranteed loan program was cut last year to $3.3 billion from $4.5 billion in fiscal year 1981—a 27-percent reduction. If the cuts for fiscal year 1983 are approved, the guaranteed loan program will therefore have been reduced by one-half in just 2 years, from $4.5 billion to $2.4 billion.

The President's Major Themes Report which accompanied this year's budget indicated that the administration plans to cut SBA guaranteed loan commitments to $1.15 billion by fiscal year 1987. These deep cuts do not come as a surprise. We have been hearing from the administration for the past year how Federal loan guarantees distort the credit markets and "crowd out legitimate private sector financing needs," to quote Lawrence Kudlow, OMB's Chief Economist. We also hear that since demand for SBA guaranteed loans is off because of the recession, the program should be cut deeply and permanently.

Unfortunately, small business special problems and needs are ignored by this administration as it seeks to justify its unilateral reductions in the SBA guaranteed loan program. Its main failing is that it ignores reality.

The reality for small business today is that it has been crowded out of the short-term bank borrowing market, the primary source of its financing. The reality is that small business demand for guar-

anteed loans will shoot up by the middle of this recession and when the long-hoped-for recovery occurs. The reality is that more capital must be made available for small business if we are to create needed new jobs and reinvigorate our economy.

The reality is that there is a need for a flexible SBA guaranteed business loan program that is attuned to small business needs and borrowing patterns—a program that helps healthy small businesses weather recession, and helps small businesses start up and expand during recovery.

This morning we shall hear from small businessmen and bankers about how SBA guaranteed loans have saved jobs, created new jobs, helped healthy small businesses through recessionary times and created new businesses at the cutting edge of technology.

We will hear how the SBA guaranteed loans are made with private money, not taxpayers' money. We will hear that lending decisions under the SBA guaranteed loan program are made by the marketplace and the local bank. We will hear that the SBA loan guarantee reduces the element of risk and provides an incentive for the bank to lend to small businesses and help their communities. We will hear how the SBA guaranteed loan program has provided an essential safety net for small business, a net that is being shredded.

Before we hear statements from other subcommittee members and panelists, I also want to mention an interesting point developed at hearings on productivity held by the subcommittee last week. We learned that the Japanese Government has four agencies that can lend, directly or indirectly, up to $20 billion to small businesses alone in that country. That demonstrates the importance the Japanese place on maintaining a vigorous small business sector. U.S. efforts pale in comparison.

Right now I would like to introduce into the text of the record an opening statement prepared by Congressman Joseph Addabbo. Without objection, it is so entered.

OPENING STATEMENT OF HON. JOSEPH P. ADDABBO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman, please accept my apologies for not being here personally, but my responsibilities as Chairman of the Defense Appropriations Subcommittee prevent me from participating in this vital exercise.

In light of your previous hearing on guaranteed loan interest rates and this current effort, I am confident that this hearing will elicit valuable insights regarding SBA's loan program.

It is no secret what my feelings are about the need of small businesses to rely on the SBA for credit assistance. The institutional impediments to small business development are just too great to rely solely on the private sector for business loans. As you know, Mr. Chairman, I feel very strongly that there is a need for SBA assistance in both direct and guaranteed loans. For that reason, I am concerned, though not surprised, with the Administration's efforts to drastically reduce guaranteed loan program levels from $3.3 billion in fiscal year 1982 to $2.4 billion in fiscal year 1983. It is just more proof of the Administration's effort to eliminate the SBA.

I know the Administration's argument for reducing the program levels is that demand has declined and guaranteed loan interest rates are higher than past years. However, I would expect today's testimony to repudiate the Administration's trickle-down proposals.

I look forward to receiving today's testimony from small businesses, economists, and lenders. Maybe we can find a way to salvage the Administration's bankrupt economic policies.

Thank you.

Mr. LAFALCE. Congresswoman Snowe, I wonder if you have any comments you would like to make?

Mrs. SNOWE. Mr. Chairman, I would just like to congratulate you for opening up a series of hearings on this important SBA program. Certainly the guaranteed loan program sponsored by SBA has been vital and essential to the development and maintenance of many small businesses nationwide. I am looking forward to the testimony presented by the witnesses here today on the proposed impact if we do, in fact, cut back on the guaranteed loan program.

Thank you.

Mr. LAFALCE. Our first two witnesses are economists: Joel Popkin of Joel Popkin & Co., Washington, D.C., and Prof. Robert Berney of the Washington State University in the State of Washington.

They will discuss the state of small business today, and small business particular credit needs and problems.

Mr. Popkin.

PANEL CONSISTING OF JOEL POPKIN; AND ROBERT E. BERNEY

TESTIMONY OF JOEL POPKIN, ECONOMIST, AND PRESIDENT, JOEL POPKIN & CO., WASHINGTON, D.C.

Mr. POPKIN. Thank you.

Mr. Chairman and other distinguished members of the subcommittee, I welcome the opportunity to describe for you the trends over the past 20 years in the share of our Nation's output of goods and services produced by small business.

Let me come quickly to one conclusion I will draw: It is that from 1963 to 1972, the share of gross national product [GNP] accounted for by companies with 500 or fewer employees fell from 43 to 40 percent. There is evidence to suggest that since 1972 that share fell further. The bulk of that decline reflects a reduction in the small business share of profits and depreciation. This suggests that an even greater relative decline has occurred in the capital intensity of small business.

These findings are based on a study prepared in 1980 by my company for the Small Business Administration. In the course of this study, we prepared the first estimates of the small and large business share of GNP. These estimates were developed from official U.S. Government data to which were applied estimation methods developed by us for this purpose. The resulting small business share data have been scrutinized by SBA and a group of U.S. Government statisticians it convened to review our estimates. Upon this review, the data proved accurate for the purposes for which they were intended, and are now widely used by policymakers and researchers as definitive on the subject.

The President, throughout his recent report to Congress on the state of small business, cited these figures on the small business share of production. The actual data appear in a table on page 229 of the report; that table is reproduced as table 1 of this testimony. Among other things, it shows that between 1963 and 1972, the small business share of gross product originating declined in every one of the eight major private nonfarm industries in the United States. The declines ranged from 1 percentage point in the services

sector to 13 percentage points in mining. The average decline in the eight industries was 6 percentage points. However, since the decline was least in the rapidly growing service sector, the overall weighted decline in small business share of GNP amounted to the 3 percentage points cited earlier.

Looked at between 1963 and 1972 in terms of payments to factors of production, the decline in small business payments to labor was 1 percentage point. But the decline in profit-type income was 3 percentage points. The decline in depreciation which, together with profits reflects cash flow, was even greater—7 percentage points. This decline was particularly noticeable in mining, manufacturing, retail trade and financial services, industries requiring substantial amounts of capital per unit of labor. As a result, it is clear that the capital intensity of small business has been declining as entrepreneurs seem to have been finding capital-intensive business less attractive.

The foregoing suggests that, despite the increase in SBA programs through most of the past 20 years, the supply of such funds may have been inadequate to permit small business to compete in capital-intensive industries on the same footing as large business. If small business has not been able since 1972 to secure adequate external funding, it is quite likely that the small business share of GNP has fallen at least as much in the past 10 years as it did in the preceding 10.

The U.S. Government data required to estimate small business share of GNP come primarily from the enterprise statistics derived from the economic censuses and from the IRS statistics of income. These data are available only with considerable lag. They became available for the year 1977, a year in which the quinquennial economic censuses are taken; they became available in December 1981. Data analyzed so far are for payrolls only; they are found in table 2 of my testimony.

These data show that payrolls paid to employees in companies with fewer than 500 employees fell from 47 percent to 45 percent of all payrolls in the 6 major nonfarm industries covered by the economic censuses. Declines occurred in each of the six industries and ranged from 1 percentage point in mining and manufacturing to 5 percentage points in construction. The decline for the average industry sector was 3 percentage points.

Thus, it would appear that between 1972 and 1977, there was a significant drop in the ability of small business, which studies show generates most of the Nation's new jobs, to create new employment at its earlier pace. Since payrolls are the largest part of GNP, if small business payrolls dropped relatively between 1972 and 1977, it is likely that the small business share of GNP dropped as well. Of course, we do not know yet whether or not other components, such as depreciation and profit-type income, continued their decline relative to large business.

It will be several years before data are available covering the period between 1977 and 1982. What those data will show can only be inferred from data on other aspects of small business that are becoming available, or have been analyzed in the President's small business report, such as the business failure rate, Mr. Chairman, that you mentioned in your opening statement. These data suggest

that the small business share may indeed have contracted further during the past 5 years.

The President, in his report to Congress, said that to him, "small business is the heart and soul of our free enterprise system." As a small businessman, I certainly share those views. Small business helps preserve competition in our economic markets and, as studies show, has generated most of the new jobs in our economy in the past two decades. But in my view, the justification for the existence of small business extends beyond economics. Opportunities in small business serve to broaden significantly the menu of opportunities for creative endeavor we Americans have before us. This, in turn, increases the vitality, ingenuity, and political freedom in our society—characteristics that are necessary if we wish other countries to follow our example.

Thank you.

[The prepared statement and biographical sketch of Mr. Popkin follow:]

PREPARED STATEMENT OF JOEL POPKIN, ECONOMIST AND PRESIDENT, JOEL POPKIN & CO., WASHINGTON, D.C.

TRENDS IN THE SMALL BUSINESS SHARE OF NATIONAL OUTPUT

Mr. Chairman and other distinguished members of the subcommittee, I welcome the opportunity to describe for you the trends over the past 20 years in the share of our nation's output of goods and services produced by small business.

Let me come quickly to one conclusion I will draw: from 1963 to 1972 the share of Gross National Product (GNP) accounted for by companies with 500 or fewer employees fell from 43 to 40 percent. There is evidence to suggest that since 1972 that share fell further. The bulk of that decline reflects a reduction in the small business share of profits and depreciation. This suggests that an even greater relative decline has occurred in the capital intensity of small business.

These findings are based on a study prepared in 1980 by my company for the Small Business Administration (SBA). In the course of this study we prepared the first estimates of the small (and large) business share of GNP. These estimates were developed from official U.S. Government data to which were applied estimation methods developed by us for this purpose. The resulting small business share data have been scrutinized by SBA and a group of U.S. Government statisticians it convened to review our estimates. Upon this review, the data proved accurate for purposes for which they were intended and are now widely used by policy makers and researchers as definitive on the subject.

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as large business. If small business has not been able since 1972 to secure adequate external funding, it is quite likely that the small business share of GNP has fallen at least as much in the past ten years as it did in the preceding ten.

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TABLE 1.—GROSS PRODUCT ORIGINATING IN SMALL BUSINESS BY MAJOR INDUSTRY DIVISION, 1955–76

[In percent]

Year	Small Business as a Percent of GNP	As a percent of private industry	Mining	Construction	Manufacturing	Transportation, communication, utilities	Wholesale trade	Retail trade	Finance, insurance, real estate	Services (less households)
1976	39	48	32	83	19	22	84	62	46	82
1975	39	47	26	83	20	18	85	63	43	82
1974	39	47	26	84	20	19	84	63	43	83
1973	39	48	31	84	21	21	85	64	45	83
1972	40	49	32	84	21	20	85	65	48	83
1971	41	49	43	84	21	21	87	65	49	83
1970	41	50	39	85	22	21	87	67	49	84
1969	41	49	39	83	22	22	87	67	50	84
1968	41	49	37	84	23	22	87	68	50	84
1967	42	50	40	84	23	23	89	70	52	84
1966	42	50	43	85	24	21	90	69	55	85
1965	43	51	45	85	24	24	89	71	56	85
1964	42	50	47	84	25	18	90	72	52	84
1963	43	52	45	86	26	26	89	73	57	84
1962	43	52	45	87	27	24	89	73	55	84
1961	43	52	50	87	27	23	90	74	54	85
1960	43	52	50	89	28	22	89	75	53	85
1959	43	51	50	88	27	20	88	75	52	86
1958	43	51	52	88	28	19	89	75	49	86

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TABLE 1.—GROSS PRODUCT ORIGINATING IN SMALL BUSINESS BY MAJOR INDUSTRY DIVISION, 1955–76—Continued

[In percent]

Year	Small Business as a Percent of GNP	As a percent of private industry	Mining	Construction	Manufacturing	Transportation, communication, utilities	Wholesale trade	Retail trade	Finance, insurance, real estate	Services (less households)
1957	44	52	53	88	29	20	89	76	51	86
1956	44	52	51	87	29	21	89	77	51	86
1955	43	52	50	87	30	23	89	77	53	87

Source: Joel Popkin & Co., "Measuring Gross Product Originating in Small Business: Methodology and Annual Estimates, 1955 to 1976," September 1980, prepared under contract for the Small Business Administration.

TABLE 2.—PERCENT OF PAYROLL COSTS PAID TO WORKERS IN COMPANIES WITH FEWER THAN 500 EMPLOYEES

	1972	1977
Mining	45	44
Construction	83	78
Manufacturing	24	23
Wholesale trade	92	88
Retail trade	61	58
Selected services	79	75
Total of above	47	45

Source: Census Bureau, Enterprise Statistics, selected years.

Biographical Sketch of Joel Popkin

Dr. Popkin is president of Joel Popkin and Company, an economic consulting firm specializing in the measurement, analysis and forecasting of specific wages and prices and the overall rate of inflation. Clients include industrial and financial corporations, law firms, the U.S. and other national governments, trade associations and international organizations.

Previously Dr. Popkin was Director of the Washington office of the National Bureau of Economic Research, and a member of its senior research staff and Senior Staff Economist at the Council of Economic Advisers with responsibility for price analysis. Prior to that he held the position of Assistant Commissioner of the Bureau of Labor Statistics for Prices and Living Conditions where he was responsible for the preparation and publication of the Government's official Consumer and Producer Price Indexes and measures of price differentials for various places in the U.S.

He also served as Chief of the Division of Price and Index Number Research of the Bureau of Labor Statistics, as an econometrician in the Office of Business Economics, and as assistant economist of the Allied Chemical Corporation. He has been on the full or part-time faculties of the University of Pennsylvania, Northwestern University and George Washington University, and had been serving as a consultant to various Federal executive and legislative bodies and to business before forming his consulting firm in July, 1978.

Dr. Popkin received his BS degree from the Wharton School of Finance of the University of Pennsylvania and his PhD in economics from the same University. He is currently on the Board of Directors of the National Bureau of Economic Research. He is also a Fellow and member of the Board of Directors of the American Statistical Association, a former Brookings Federal Executive Fellow, and was Chairman of the Board and President of the National Economists Club.

Several years ago Dr. Popkin developed a macro econometric model of the U.S. integrating final demand with intermediate output, disaggregated by stage of process. This stage-of-process model is used to analyze inflation and its transmission through the economy and for the analysis of sectoral changes in productivity, wages and other costs affecting prices. It has been the subject of articles in economic journals and business publications such as Fortune and Business Week.

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In addition to projects based on the stage-of-process approach, Dr. Popkin and his Company have worked on a broad range of topics for clients. These include the development of special price indexes for use in escalation of wages, pension plans and other contractual arrangements, various projects related to inflation accounting, and model building and forecasting at the macro, industry sector, market, and firm level.

Mr. LAFALCE. Thank you very much, Dr. Popkin. I have many questions, and I am sure Congresswoman Snowe does too. Before we get into the questioning, we will hear from Prof. Robert Berney. I think that this is the second appearance that Professor Berney is making before this subcommittee. Because of his distinguished background and great work in the area of the small business sector, we are delighted to have him back, and look forward to future appearances also.

TESTIMONY OF ROBERT E. BERNEY, PROFESSOR OF ECONOMICS, WASHINGTON STATE UNIVERSITY, PULLMAN, WASH.

Mr. BERNEY. Mr. Chairman and distinguished members of this subcommittee, it is indeed a pleasure for me to again be testifying before you on what is happening to smaller businesses in our economy. It bothers me that we always preface this by "small," because when you are talking about 98 percent of the businesses in our economy, you are obviously dealing with an extremely crucial economic area, extremely significant supply-side economic programs, and obviously an important political issue because, after all, there are 15 million small business voters.

Small business issues are no longer partisan with the introduction of this excellent report by the President on "The State of Small Business." It is clear that small business problems are a primary concern for both political parties today.

Joel Popkin has indicated that, in the longer run, small business is being crowded out of the production process for GNP, and in particular the capital intensive small businesses are being squeezed out. I think part of the reason for this structural change is the restructuring of our financial markets which are leading to larger and larger financial institutions. This change will make it easier for the larger firms to buy out small firms; but, it is going to make it more difficult for small firms to meet their credit needs after an initial flurry of competition when these new financial conglomerates establish their competitive positions in the market.

I have been teaching a course in money and banking this year, and it is frightening to see what is happening to the financial markets. We have growing evidence that it is the small unit bank that provides most of the lending to small firms. And it is these small banks which are crowded out by the new financial conglomerates. Thus the small firm is going to be in more and more trouble in meeting its capital and credit requirements. This indicates, that because of the changing nature of our capital markets, the SBA lending program is going to become more and more important in maintaining an adequate flow of credit to the smaller firms.

Most of the good studies on small business issues are the direct responsibility of the House and Senate Small Business Committees, so I want to congratulate you all for the kind of work that you have done in putting together bills that, first of all, require the

President to make an annual report on the state of small business; and then, second, these Studies on Small Business Finance by the Interagency Task Force on Small Business. Again, it is due to your diligent efforts.

Mr. LAFALCE. What is the date of that, Professor Berney?

Mr. BERNEY. This one?

Mr. LAFALCE. Yes.

Mr. BERNEY. I just got this set recently. The paper I am referring to was completed in January 1982. It is by Cynthia Glassman and Peter Struck, and is entitled "Survey of Commercial Bank Lending to Small Business," in "Studies of Small Business Finance," by the Interagency Task Force on Small Business.

What I want to discuss with you today are some of the cyclical things that are happening which are going to magnify the crowding out that Joel Popkin has been talking about which have occurred over the last decade.

The hypothesis I have been advancing is that business cycle impacts the small firm much more severely than the large firm. I noticed that the President's report agrees with this analysis.

You mentioned some of the Dun & Bradstreet statistics. A recent Wall Street Journal article gave the most current data on business failures and they are depressing. In the first 8 weeks of 1982, business failures were up 55 percent over the last year; in manufacturing, they were up 69 percent; in wholesaling, they were up 73 percent. The initial upsurge in business failures was in retailing. Now, as the recession continues, it is seeping into the very guts of our economy.

Clearly the cyclical impact on small firms are growing, and it is getting worse all the time. The question is: What can we do about it?

One of the basic problems is that interest rates are not falling and loans are not becoming more readily available as has been true in most recessions. Where businesses could pass on higher interest costs during a period of inflation, in a period of collapsing demand and, if anything, weakening prices, small firms cannot pass on these high costs of getting credit. So again, we need some kind of lending program that will provide funds at a reasonable cost to the smaller firm.

The President has talked about the importance of maintaining a safety net for people who are thrown out of work through conditions beyond their control. I think your suggestion that we ought to set up a safety net for small business is equally important. Part of the reason of this, as I see it, is that Government policy for fighting inflation hits small firms more heavily than large firms. Borrowing money to balance the budget hits small firms more than large firms. Small businesses are firms that will be crowded out of the tight credit markets caused by Government policy.

What I am saying is that we don't have perfect competition in the capital markets. We have Government interference in the credit markets. This is what is causing small business to be crowded out of these markets. So it makes sense to have the safety-net program where SBA continues to provide loans for the small business sector.

I also think it would also be useful to gear up SBA's direct lending program. This isn't the topic of this hearing I know, but SBA has always provided excellent service during a period of emergency. For instance, they were out in the State of Washington providing emergency loans after Mount Saint Helens blew its top. I wonder how bad the economic conditions have to get before we take seriously that SBA could be making emergency loans with their disaster teams in areas like yours where unemployment is over 15 percent?

Mr. LAFALCE. The unemployment is 14.3 percent in the Buffalo-Niagara Falls SMSA and 14.9 percent in Niagara County, and in surrounding counties. In Orleans and Genesee Counties, it is over 15 percent; it is really bad.

Mr. BERNEY. We have rates like that in the States of Washington and Oregon.

The question again is: Why doesn't the SBA have an emergency loan team in the areas of our economy where unemployment has gone over 15 percent. It is clearly as much of an emergency as St. Helens erupting, an earthquake, flood, hurricane, or other natural disaster.

SBA should also have a guaranteed lending program that, rather than moving in a procyclical manner, increasing in size as the economy expands, should be expanding as business contracts. I would like to suggest that you tie the size of the SBA lending program to the bankruptcy rate or the increase in the unemployment rate, so as the economy collapses, SBA would become even more active in its lending. SBA should be even more a lender of last resort to smaller businesses as their cash flow is squeezed because of collapsing sales due to the contracting economy.

What would happen if SBA's guaranteed loan program was increased by 50 percent over fiscal year 1981? This would mean that SBA could guarantee something like 12,000 more loans to cash-starved firms, which we can assume would be forced out of business without these loans. Conservatively, SBA would be protecting something like 94,000 jobs.

I was reading the forthcoming testimony by Arthur Mitchell of the Capital Bank & Trust of Baton Rouge. He is suggesting that if we made those additional loans in this area we could save something like 136,000 jobs, and maintain some $6 to $7 billion in lost sales.

In summary, emergency direct and countercyclical guaranteed loans are the two kinds of safety nets that I think are available to the House Small Business Committee to recommend. It seems crucial to me that SBA be asked to step into the breech of what is happening to our economy. I don't think SBA officials can seriously argue that we really now have perfect capital markets for small firms so that there is no longer a need for this kind of program. Maybe in the mythical world of economists, where we have perfect competition and perfect capital markets, we wouldn't need SBA. But we are a long way from that. Because the burdens of Government, and the burdens of the recession are most heavily falling on the small firm, I think it is crucial to maintain SBA's lending programs. If anything, these programs must be expanded in the near term if the economy continues to decline.

Thank you very much.
Mr. LAFALCE. Thank you very much.
[The prepared statement of Professor Berney follows:]

PREPARED STATEMENT OF ROBERT E. BERNEY, PROFESSOR OF ECONOMICS, WASHINGTON STATE UNIVERSITY, PULLMAN, WASH.

THE CROWDING-OUT OF SMALL BUSINESS FROM THE AMERICAN ECONOMY: A CYCLICAL CRISIS IN THE MAKING

It is indeed a pleasure for me to again be testifying before you on what is happening to smaller businesses in our economy. When you are talking about impacts which affect over 98 percent of all businesses in our economy, you are obviously dealing extremely crucial economic issues, extremely significant supply-side economic concepts and obviously important political issues, as there are some 15 million small businesses in our economy.

The fact that the President recently released his, "Annual Report on Small Business and Competition" and the outstanding companion study entitled The State of Small Business, A Report of the President (March 1982) suggests that the concern for maintaining a healthy, dynamic small business sector is an important bipartisan issue.

LONGER-RUN TRENDS

Joel Popkin has just presented evidence to show that in the long run small business is being crowded out of our economy. In particular, smaller firms are being crowded out of the sectors which are most capital-intensive, reflecting the problems that many small firms have in raising sufficient funds to finance their plant and equipment needs. If real interest rates continue at these unusually high levels, as we both anticipate, then the long-run financial problems of small firms will continue and their share of GNP will further decline.

The restructuring of our financial markets which is leading to larger and larger financial institutions will make it easier for our largest firms to get the monies needed to buy out successful smaller firms. But after a brief flurry of increased competition when the large financial conglomerates establish their market positions, the availability of funds for small-firm start-ups or expansions will become even harder to obtain. I hope the House Small Business Committee will continue to keep a watchful eye on how the restructuring of our financial institutions affects small business. Frankly, I am worried that the changes will discriminate even more against the new, small firm, reducing the amount of competition and innovation we have in our economy.

SHORT-RUN TRENDS

What I want to discuss today is some of the cyclical changes which are magnifying the longer-run, crowding out problems for small businesses that Joel Popkin has demonstrated.

My comments will be more theoretical in nature and will be backed by only fragmentary evidence because of the long lags in obtaining Census and IRS data. Hopefully, three years from now SBA's data base effort will have progressed far enough to provide the data that Joel and I both need to more adequately prove our points. It is crucial that the momentum started in 1978 by the House and the Senate Small Business Committees to get SBA to develop a usable data base be continued. Good progress continues to be made in this area. But data base development and, as important, funding research using the data base are of crucial importance in the coming fiscal years.

You should plan to hold annual hearings on the data base development effort to insure that the funds are wisely spent. As was pointed out at the recent Small Business Research Conference, data availability is still the most serious problem in doing serious research on small business.

Cyclical sensitivity of small business

A hypothesis that I have been advancing for several years is that the cyclical swings for small firms is much larger than for larger firms and the economy as a whole. Now, there is a growing body of evidence to support this contention. Even the President in his Annual Report on Small Business and Competition states:

"By the very nature of their structure, resources, and to some extent the types of activities in which they participate, small firms tend to be highly susceptible to the

ups and downs of overall economic activity. Small businesses have fewer resources than larger businesses to survive cyclical downturns and are more likely to fail." (p. 8)

Later the Report states:

"While the experience of small firms during the peaks and troughs of a business cycle are of general interest, it is the bottom part of the cycle that generally gives rise to an increased demand for government intervention. At the trough of the cycle, the profit position of the small firm is at its lowest, and business failures are at their highest." (p. 85)

Current business failure and bankruptcy data, which show that the numbers are approaching levels reached only in the 1930s, substantiate the cyclical sensitivity of smaller firms and the need for some new policy actions.[1]

The current credit problems of small business

For several years I have argued that smaller firms are more severely impacted by tight money policies than are large firms.[2] The basic argument goes as follows: The debt-equity ratio for smaller firms tends to be greater than for large firms, particularly in manufacturing, construction and the distributive trades; the percent of short-term debt to total assets tends to be higher for smaller firms than larger firms and this percent has been growing in recent years; and the ratio of indebtedness to banks to total indebtedness has been growing more rapidly for smaller manufacturing firms than larger manufacturing firms.

The implication I draw from these relationships is that the cost and availability of commercial bank credit tends to be more important for the smaller firm than for the larger firm. Consequently, tight credit policy impacts the smaller firm more severely than the larger firm.

Exactly the same conclusions are found in the President's report, The State of Small Business:

"Since approximately 80 percent of small businesses rely on financing from depository institutions, an increase in the cost of financing and a decrease in the availability of funds from these institutions has a more severe impact on smaller firms than on larger firms. Small firms experience the impact sooner and for a longer duration. Further, small firms tend to have a higher debt-equity ratio and have a greater dependence on current debt . . . The shorter maturity of the debt structure for small businesses makes these firms more vulnerable to sharply rising interest rates. Their interest costs increase in response to rapidly increasing short-term rates. Moreover, failure to obtain loan renewals results in an immediate liquidity crisis for these firms.

"Rising interest cost burdens in an economy of sluggish sales and a decline in the inflationary rate spell disaster to the cash flow position of a small firm. Although cash flow will eventually improve when inventories and receivables adjust to the lower level of sales, the persistence of high interest rates during the past year and a half has increased pressure on the liquidity position of many small firms. Small businesses have suffered larger declines in sales and profits, particularly during recessions, experience greater cashflow problems, and must close their doors or declare bankruptcy when these acute profit and cashflow problems are not alleviated by financing from banks or suppliers." (p. 122)

While we may expect some relief from the Federal Reserve's tight money situation given the low rates of inflation which have occurred in recent months, the extremely large deficits which are being forecast by the Administration and the Congressional Budget Office will have similar impacts on the small business sector.[3] Large deficits, which are not monetized by the Federal Reserve, will crowd out smaller firms from the credit markets.

Those firms which can still get credit will be paying higher interest rates. Unfortunately, monetizing the debt is equally bad, since that means higher inflation, and higher interest rates and then a renewed tight money policy. The only answer is to do a better job of balancing the budget.

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[1] For more details see: The State of Small Business: A Report of the President, March 1982, pp. 78–85.

[2] For example, see my testimony in "Federal Policy and Its Effect on Small Business, Part 1—Increase in Interest Rate," hearings before the Subcommittee on Access to Equity, Capital and Business Opportunities of the Committee on Small Business, House of Representatives, 96th Congress, 1st sess. Oct. 30, 1979.

[3] See my "Deficit Spending Steals Money From Small Companies," Inc magazine, August 1981, p. 14.

A MORE OPTIMAL POLICY FOR SMALLER FIRMS

The President has already outlined the first basic tenet of a more optimal small business policy:

"The fundamental tenets of small business policy are thus quite clear. Government should promote a strong, vibrant, private economy with policies that primarily rely upon free market forces to organize and allocate our economic resources. Economic growth and full employment must be restored while reducing inflation and interest rates, and, at the same time, Federal impediments to the free and efficient use of resources must be reduced or eliminated." (p. 5)

The second tenet for a better set of small business policies is found in my "Small Business Policy: Subsidization, Neutrality or Discrimination":

"The conclusion is that a strong case can be made for government to provide special programs to support smaller businesses in their competition with larger business. . . . [because] there is a growing body of evidence to suggest that the impacts of government policy are not neutral, but significantly discriminate against the smaller firm . . . all that is being recommended is that the government, as a first step, should equalize its burdens and benefits on firms of varying size so that governmental policy is basically neutral." [4] (p. 1 & 26)

Longer-run policies

Due to your efforts the Regulatory Flexibility Act, the Paperwork Reduction Act and the Equal Access to Justice Act were passed in 1980. They are all part of an important first step since, over the longer-run, they create the possibility that the non-neutralities in government policy which have accumulated over the last two decades can be corrected. The adoption of the progressive tax rate structure for the corporate income tax in 1978 was also an imortant first step in offsetting some of the non-neutralities.

Counter-cyclical policies

But none of these policies meet the cyclical needs of small business today. None of these will slow the rising number of bankruptcies and business failures. Neither does the Economic Recovery Tax Act of 1981 help the firm that is faced with growing losses because of depressed economic conditions.

The President talks of the importance of maintaining a "safety net" of government policies for those who, through conditions beyond their control, are thrown out of work. A similar safety-net for small business needs to be developed. Because government policy of fighting inflation and borrowing money to balance the budget has restricted the availability of credit to small firms more than large firms, because the policy-created recession has impacted small firms' sales and profits more than large, a new set of counter-cyclical policies aimed at small business need to be developed.

As shown in The State of Small Business (p. 140), the number of SBA loans and the amount of direct and guaranteed loans in real terms, have declined since fiscal year 1978. The average loan size, again in real terms, declined from $70,956 to $61,853 from fiscal year 1978 to fiscal year 1981, when fewer than 29,000 firms received loans. During a period of cash flow crisis and rising bankruptcies like we now face, the numbers and average size of SBA loans should be rapidly increasing. Perhaps the number of loans and the size should be inversely tied to some index of small business vitality. For example, SBA lending could go up by the same percentage as the increase in bankruptcies and/or unemployment.

What could happen if SBA would increase its guaranteed lending by 50 percent over fiscal year 1981? It would make 11,600 additional loans to cash-starved firms which we can assume would otherwise have been forced out of business. If we further assume the average employment size of each firm is 8.1 employees and the average sales size is $552,000 (1976 averages from Dave Birch's Dunn and Bradstreet data base) then the counter-cyclical loan program would protect 93,960 jobs, and $6.4 billion in sales at a cost of $1.5 million in additional guaranteed loans. (This is assuming the average size of guarantee loans in fiscal year 1981 is maintained at $132,000.)

In summary, establishing a counter-cyclical, guaranteed loan program for SBA is the most important thing the House Small Business Committee might do to provide a safety net for small businesses.

However, since SBA lending programs reach such a small percentage of small firms (less than 3/10ths of one percent of 14.7 million firms) some longer-run policy

[4] For additional discussion see: "The State of Small Business: A Report of the President," p. 133-80.

action by the Federal Reserve would be even more desirable: The following quote from Walter W. Heller in a recent Wall Street Journal guest editorial is suggestive in this regard:[5]

"A second step would be for the Fed to provide informal credit guidance, a few words to the wise in the banking community asking them to conserve the limited supply of credit, to guide it into the most productive channels. It would not take a very heavy hand to dissuade bankers from pumping money into corporate takeovers, commodity speculation and excessive foreign loans in order to give higher priority to plant and equipment investment, farming, small business, residential construction and the like.

"This guidance or 'credit conservation' would be a logical counterpart to the tax guidance so liberally practiced by the White House and Congress in the Economic Recovery Act of 1981. For example, savings are guided—almost bludgeoned—into All-Savers Certificates. Business funds are lured into buildings, refineries and long-lived equipment by 15-10-5-3 depreciation and so forth.

"Funds are nudged into public utilities through tax-free dividend reinvestment. Moribund companies are given succor through juicy tax-sheltered leasing arrangements. For the Fed to guide lendable funds into constructive and productive uses is surely no greater interference with private markets than the powerful tax guidance encoded in the 1981 act."

The Federal Reserve tried this sort of thing on Oct. 23, 1979 in a letter from Paul Volcker to the Chief Executive Officer of each member bank:

"As I indicated in my letter of October 10 to member banks with deposits in excess of $100 million explaining the new actions, the Board does request that banks take care to avoid financing essentially speculative transactions in commodity, gold and foreign exchange markets. In addition, except as they may clearly involve an improvement in the nation's productive capabilities, credits advanced for extraordinary financial transactions would be viewed as questionable by the Board. Examples would include loans for the purpose of retiring stock or for corporate takeovers that simply substitute one source of financing for another and do not clearly promise improvement in economic performance. There should not, of course, be any questions about credit normally advanced to financial concerns and others in the ordinary course of business.

"Conversely, lending institutions need to be alert to the continuing need for credit to finance the basic needs of the economy. In accommodating these needs, we believe banks should take particular care that small businesses, consumers, home buyers, and farmers continue to receive a reasonable share of available funds. Loans to such borrowers, as well as to larger business customers that require bank credit in support of their normal operations, will encourage an orderly process of economic adjustment toward greater stability and help to sustain key sectors of local and national economics."

Whether this form of moral suasion was effective is difficult to say. Probably a more formal, credit allocation system is needed. This is obviously a topic for another hearing.[6]

CONCLUSIONS

Joel Popkin shows, that since 1963, the small business share of GNP has declined and is expected to continue to decline. The reason for this crowding out was discussed in my earlier testimony before this committee.[7] Today we are faced with a more serious crisis. Tight money policies, large government deficits and a serious recession are forcing more small firms to close their doors than since the great depression. A primary cause of this crisis is a) the discriminatory impacts upon smaller firms because of the Federal Reserve tight money policy, b) the recession Federal Reserve Policy is creating, and c) the government's large deficits. To correct this crowding out of small business from the credit markets, the government needs to develop some new creative financing schemes. The one policy most readily available to this committee is to make SBA guaranteed lending more readily available. Using

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[5] Walter W. Heller, "Reaganomics: Is That All There Is," Wall Street Journal, Oct. 6, 1981.

[6] In this regard you should be aware of the following study: Brimmer & Co., Inc., "Monetary Policy, Interest Rates and Credit Allocation for Small Business," U.S. Small Business Administration, Aug. 29, 1980.

[7] "Moving Towards a More Optimum Policy Towards Small Business" and "The Changing Face of America's Small Business Sector" in Impact of the Reagan Economic Program on Small Business, hearing before the Subcommittee on General Oversight of the Committee on Small Business, House of Representatives, 97th Congress, 1st sess., May 19, 1981, p. 17-54.

SBA's disaster loan terms in the states most seriously depressed is one technique that might be used.

Longer-run policy change would be to get the Federal Reserve involved in emergency credit allocation, as it has been: (a) For large business with the pending collapse of the Penn Central in 1970, (b) for a large bank with the pending failure of Franklin National Bank in 1974, and (c) for building and land speculators with the problem facing the real estate investment trusts in 1974, Creative financing schemes by the Federal Reserve would probably be more useful to the small business community than a countercyclical SBA policy because the Fed's policies could reach a much larger number of firms. But if the economy continues to deteriorate and bankruptcy rates continue to rise, both emergency efforts are clearly needed.

TOTAL SBA DIRECT AND GUARANTEED LOANS: FISCAL YEARS 1972–81

[In millions of dollars]

Fiscal year	Number	Dollars	Constant dollars (1972)
1972	27,749	1,369.8	1,369.8
Direct	8,127	198.5	198.5
Guaranteed	19,622	1,171.3	1,171.3
1973	33,650	1,942.3	1,937.7
Direct	6,430	234.1	221.5
Guaranteed	27,220	1,759.2	1,664.5
1974	27,273	1,757.9	1,529.7
Direct	5,623	196.6	171.1
Guaranteed	21,830	1,561.3	1,358.6
1975	22,241	1,431.0	1,139.7
Direct	6,046	253.7	202.1
Guaranteed	16,195	1,777.3	937.6
1976	26,978	2,102.6	1,591.6
Direct	5,577	236.9	179.3
Guaranteed	20,501	1,865.7	1,412.3
1977	31,793	3,154.4	2,255.9
Direct	6,673	344.9	246.7
Guaranteed	25,120	2,809.5	2,009.2
1978	31,650	3,402.8	2,267.8
Direct	6,080	339.7	226.4
Guaranteed	25,570	3,063.1	2,041.4
1979	30,096	3,501.1	2,150.9
Direct	6,150	380.6	233.8
Guaranteed	23,946	3,120.5	1,917.1
1980	31,519	3,569.2	2,011.4
Direct	6,586	392.9	221.4
Guaranteed	24,933	3,176.3	1,790.0
1981	28,650	3,393.8	1,772.1
Direct	5,437	333.0	174.3
Guaranteed	23,213	3,060.8	1,597.8
Total	291,599	25,624.9	17,926.6

Source: Office of the Controller, Budget Division, U.S. Small Business Administration.

MICROFILMED FROM
BEST AVAILABLE

ECONOMIC ISSUES

DEFICIT SPENDING STEALS MONEY FROM SMALL COMPANIES

When the government competes with business for credit, guess who wins.

By Robert E. Berney

Republicans have always paid lip service to the idea that federal budget deficits are inflationary. But what's this new tune the Reagan team is whistling? Deficits are okay, they say, just so long as the Federal Reserve keeps the money supply in check.

Really? Does this mean you can shuck your worries about a growing federal debt?

Not if you're a small business owner. Even if the Reagan Administration achieves its basic economic objectives—slower monetary growth, lower spending, lower tax rates, and reduced regulation—an unbalanced federal budget will be bad news for small companies.

The federal deficit during this fiscal year is expected to approach $55 billion. The deficits in fiscal years '82 and '83 will depend upon how much of the Reagan economic program Congress finally adopts, but the Administration itself has projected a $45-billion shortfall next year. It could be higher. In any case, the Federal Reserve has just two options, and the first one is clearly inflationary.

The Fed could, as it has done in the past, monetize portions of the debt, which amounts to printing money. The Fed buys government securities held by banks, thus increasing the banks' cash reserves. The banks use the reserves to create loans, leading to a multiple expansion of the country's money supply. All this would boost inflation, and interest rates would rise along with expectations of still more inflation. You could then expect the Fed to respond with a set of tight money policies similar to those imposed twice in the last two years. If you have any doubt about the effect of tight money on interest rates and on the small business sector, check the increases in bankruptcy filings that followed the Fed's moves in October 1979 and March 1980.

Of course the deficit doesn't have to be monetized. By not making offsetting debt purchases from banks, the Fed can force the government to compete for credit with private borrowers. Who do you think will come off best in that competition?

As conservative economists correctly reminded earlier Democratic administrations, the government will always crowd private borrowers out of a tight credit market. Big companies can still raise capital by issuing stock. Or they can tap the Eurodollar market, insurance companies, trust and pension funds, or commercial credit instruments. Small companies will still have to go to the bank, where interest rates will probably be setting new record highs and where adequate credit supplies probably will not be available at any price.

For small companies, therefore, there is but one basic difference between the two policies. Credit supplies will dry up more quickly if the Fed does not monetize the federal deficit. If it does, they'll still dry up, but not as soon. In either case, the economic effects of the Administration's supply-side policies will be swamped by the size of the federal budget deficit.

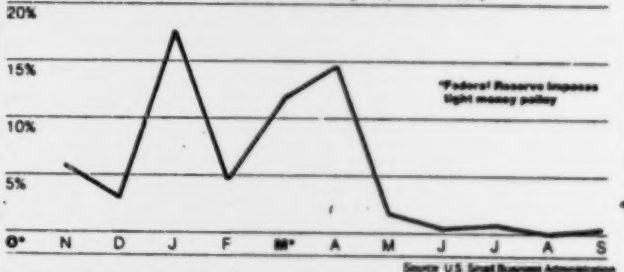
The problem could be avoided without dramatically altering Reagan's economic plan. Since cuts in the personal income tax rate are less effective in stimulating additional output than are accelerated depreciation or other business tax cuts, the first cuts in personal tax rates should be delayed at least until January 1982. Then the 30% reduction should be spread over five years instead of three. This gradual approach to cutting personal taxes would still generate the incentives to work harder and save more, but it would avoid the problems associated with large budget deficits. In addition, Congress would be under pressure to continue to reduce the size and spending burden of government.

How quickly and how thoroughly supply-side adjustments operate depends upon the competitiveness of the economy. The more dynamic the small business sector, the more rapidly innovations and productivity increases will spread throughout the economy. Small and rapidly growing businesses, however, benefit most from adequate supplies of capital and credit and a rapidly growing, noninflationary, free-market economy. That is why balancing the budget is still as important as reducing regulation, slowing monetary growth, cutting taxes that restrain entrepreneurial activity, and cutting the level of government expenditures.

Republicans should not be so eager to abandon their belief in the value of a balanced budget, now that they have the clout to balance one. □

A professor at Washington State University, Robert E. Berney specializes in the economics of small business.

BANKRUPTCY FILINGS (October 1979 through September 1980)



Source: U.S. Small Business Administration

Following the imposition of new tight money policies by the Federal Reserve in October 1979 and March 1980, interest rates soared, and so did bankruptcy filings, shown here as the percentage change from the previous month's filings.

Mr. LAFALCE. Dr. Popkin and Professor Berney, I would like to explore with you the data base. Dr. Popkin, you referred to the reduction in a share of the GNP using the period 1963 to 1972. I think that is the last information we have. Is that correct?

Mr. POPKIN. That is the last complete information. We have information on the payroll part of GNP through 1977; it also shows a decline.

Mr. LAFALCE. What is the reason that we have such a lag? Is it directly related to the census?

Mr. POPKIN. The lag on the payroll part is due to the fact that it relies on data collected from the economic censuses, and those data are taken only every 5 years. There is a lag, as you can see. In December of 1981, the economic census data for 1977 just became available. So that is a 4-year lag.

The other lag is in the IRS data. These are data that the IRS compiles from individual tax returns. To get all of the volumes of tax return statistics that are needed takes several years for the IRS at this time.

Mr. LAFALCE. When will we be able to have additional data on the percentage of GNP that is generated by the small business community? The last we have on that is 1972.

Mr. POPKIN. I think it will be possible this year to provide estimates for the year 1977. But to bring 1977 forward to 1982, my guess would be, if history repeats itself, it is going to be 1985 or 1986.

Perhaps there might be some room to develop a basis for updating the estimate of small business GNP on a more current basis, perhaps by some subsampling device or something, if the committee were interested in that.

Mr. LAFALCE. I think this could be extremely important, not just to know what has gone on so we can see the trends, but perhaps to help us better project the future impact of actions we might take.

Professor Berney, you mentioned in your prepared statement a suggestion that perhaps the committee should have hearings on the data base development effort. Could you expand upon that a bit? Explain to me what this Small Business Research Conference was.

Mr. BERNEY. In Boston, there is an annual Small Business Research Conference which is held at Bentley College. Both Joel Popkin and I were there presenting papers 2 weeks ago.

Mr. LAFALCE. Who sponsors it, the college itself?

Mr. BERNEY. The Small Business Foundation of America of SBANE is one of the sponsors, and the college is the other sponsor. Ann Eskesen is the contact person at Bentley, and she has done an outstanding job gathering together the people who are doing significant research on small business issues. One of the key topics this year was the problem of an inadequate small business data base. The fact is that we don't have current data to do significant research. This was clear to me as Chief Economist for the Small Business Administration when I was here between 1978 and 1980. It has also been clear to your committee, but you need to continue to bring pressure on SBA to continue its development of the data base. They are doing a good job now. The effort is moving slowly forward. I think you are getting substantial returns on your money.

But the pressure by the committee needs to be continued so that spending for this important project is not reduced during this period of extreme budget reductions.

Mr. POPKIN. Mr. Chairman, if I could add to my earlier response to your question, it might be possible for organizations like the Census Bureau, in their monthly collection of retail sales data, for example, to publish estimates divided by whether that response was from a large business or a small business; they would have some idea of who they were sampling for these statistics. Now, of course, that will just get you into trade. You probably could do something in the manufacturing sector because there are lots of monthly data on manufacturing. I think the biggest gap would be services, and possibly construction, which are very important sectors for small business, although these are sectors for which we don't have much economic data of any type.

Mr. LAFALCE. I share your thoughts, and I think that this is an avenue that this subcommittee should pursue in the immediate future. It is very important, and it is an area that we haven't pursued aggressively enough and given isolated attention to.

Let me pursue an area that I think is extremely important for you to comment on. Professor Berney, you mentioned that you teach a course in money and banking. I also serve on the House Banking Committee, and I am very concerned about the plight of our financial institutions. The solution of this plight of our financial institutions seems to be merger, merger, merger. We are going the way of larger institutions, with one-stop shopping for all our financial services, et cetera.

I am going to read to you the following:

> Small businesses compete with large businesses for banking funds, the most important source of financing to small business.

Continuing the quote:

> Statistics have shown that during tight money periods, large businesses move into short-term markets because they defer the issuance of corporate bonds in the bond market. Consequently, small businesses are less able to compete in the bank loan market during tight money periods.

Continuing from the same source:

> It is clear that the small business share of total loans approved has dropped substantially during 1981. There is a "crowding out" of small business as banks choose to meet the large loan demands of larger firms.

Continuing from the same source: "Small-size loans, those over $500,000, have fallen from a recent high of 51 percent of all short-term bank loans"—that was in February of 1979—"to a low of 17.3 percent in August of 1981."

Now I am quoting not from the New Republic or the Brookings Institution, I am quoting from President Reagan's March 1982 "State of Small Business" Report.

Since President Reagan has made this statement on the unbelievable crowding out phenomenon taking place, where large businesses are taking a much larger share of the available credit than small businesses, what should we do about it? Do you think we should cut the guaranteed loan program from $4.5 billion to $2.4 billion as a solution to that problem?

Mr. BERNEY. That is obviously not my solution. I think we should be moving in the opposite direction. As I said in my testimony, I think this basic restructuring of our financial community means that SBA needs to take a more active role in guaranteed lending, and even direct lending, than it has in the past. The need is clearly there.

I am not blaming the banks. I know that we have bankers here and they are going to say clearly they are making more loans to small business, and some of them are. But if I was profit maximizing banker, I would go to the bigger loans because there are fewer transaction costs and this sort of thing. So it is logical that the larger units sell to larger business units. So I think the natural trends in our economy is that the small firm is going to be more and more crowded out and we need to develop institutions to protect that from happening.

Mr. LAFALCE. Dr. Popkin?

Mr. POPKIN. If I could just tack a footnote on to what Bob said, one of the functions our company performs is to forecast the economy in the years ahead. We specialize in forecasting prices and, if you forecast prices, you are supposed to be able to forecast interest rates. Our current forecast is that long-term interest rates will remain near present levels for the next couple of years. In fact, they are not going to come down.

Mr. LAFALCE. How about short-term?

Mr. POPKIN. Short-term rates will probably come down to about 13 percent.

Mr. LAFALCE. What do you call short-term?

Mr. POPKIN. That is the 3-month Treasury bill, that is not the prime. The prime we can expect to be higher than that.

So I think that lenders are going to require a larger premium over the inflation rate for making a long-term commitment, as compared to what they used to do in the past. So I think that whatever policies are put into programs by this committee should take account of what is likely to be a continued high cost of borrowing, no matter where the funds come from.

Mr. LAFALCE. Thank you very much.

One last question before I turn the discussion over to Congresswoman Snowe. Professor Berney, you made reference to the interagency task force report. Would you care to make any comments regarding that report or summarize it?

Mr. BERNEY. I was just referring to one paper in the series. There are about 20 papers in the project. I am a little bit biased about their quality and scope since I had something to do with creating and managing the entire study. But I feel it is an excellent collection of papers. It might well be worth a hearing on this collection of studies if you haven't already had that sort of thing.

[The list referred to above follows:]

LIST OF PAPERS IN THE STUDIES OF SMALL BUSINESS FINANCE

Cynthia A. Glossman and Peter L. Struck, "Survey of Commerical Bank Lending to Small Business".

Martha S. Scanlon, "Relationship Between Commerical Bank Loan Size and Size of Borrower".

Thomas F. Brady, "Commercial Bank Business Lending By Size of Loan".

Neil B. Murphy, "Loan Rates, Operating Costs and Size of Loan: The Evidence From Cross-Section Data".

Bernard Shull, "Changes in Commerical Banking Structure and Small Business Lending".

Donald T. Savage, "American Commerical Banking Structure and Small Business Lending".

Harry P. Guenther, "The Impact of Bank Regulation in Small Business Financing".

Victor L. Andrews and Peter C. Eisemann, "Who Finances Small Business, Circa 1980?".

Hans R. Stoll, "Small Firms Access to Public Equity Financing".

John J. McConnell and R. Richardson Pettit, "Application of the Modern Theory of Finance to Small Business Firms".

Timothy Bates, "A Review of the Small Business Administration's Major Loan Programs".

David J. Brophy, "Equity Participation Agreements and Commercial Bank Loans to Small Business".

Stuart I. Greenboum, George Kanatas and Sudhalzao D. Deshmukh, "Credit Rationing and Small Business Finance".

Oswald D. Bowlin, "Lease Financing: An Attractive Method of Financing for Small Firms".

Lewis Mandell, "Credit Cards and the Financing of Small Business".

Robert Mittelsteadt and Manferd O. Peterson, "Franchising and the Financing of Small Business".

R. Richardson Pettit and John J. McConnell, "The Impact of Usury Laws on the Effectiveness and Efficiency of the Operation of Small Business".

Thomas S. McCaleb, "Tax Policy and Small Business Financing".

Richard Zock, "Small Business Access to Capital Markets Through Pension Funds".

Paul S. Anderson, "Business Development Credit Corporations".

Lawrence J. White, "Role of Small Business in the American Economy".

Staff of the Interagency Task Force on Small Business Finance, "Responses to the Small Business Administration *Federal Register* Notice Requesting Small Business Comments on Credit Needs".

The general editor for the Project was Paul M. Horvitz, Professor of Finance at the University of Houston. The studies were financed by SBA as part of the Interagency Task Force in Small Business Finance.

Mr. BERNEY. But the paper I was referring to reported on a survey of commercial bank lending. The data that they have clearly shows that the small unit bank is the most active lender to small business; the large multibank holding companies and other large banks primarily deal with larger firms. So it is clear the changing of the financial structure is going to make it more and more difficult for small firms to get the loans they need to get started and then to expand.

Mr. POPKIN. Mr. Chairman, if I could just add something to that, I was interested to read the other day that, while banks are infrequently chartered in the District of Columbia, a bank that is in the process of being chartered right now, or has been chartered, I believe, by the Congress, has announced that it is going to specialize in small business lending. It seems to me that if a group of investors would put together a bank explicitly for that purpose in these times, there must be a tremendous demand on the part of small businessmen who have not been able to find adequate financing.

Mr. LAFALCE. Thank you.

Congresswoman Snowe.

Mrs. SNOWE. Thank you, Mr. Chairman.

I gather from both your testimonies that you both agree that this would be the wrong time to cut back on the guaranteed loan program or any other type of programs that SBA offers.

Mr. POPKIN. Well, it certainly is clear to me that the small business share of GNP has been falling, it looks like it has continued to fall, and that implies that in order to keep it from falling, one either has to step up the programs, or at least keep them at the recent level. It would seem to follow that a reduction in those programs would reduce the small business share even more.

Mr. BERNEY. I think I would make the same basic argument, particularly since we are in a recession and small firms are taking the greatest impact of the recession. Now is not the time to cut back on these small business programs, particularly SBA guaranteed lending.

I think it might also be useful to—and I know that is not the purview of this committee—lean on the Federal Reserve to insure that a proper allocation of credit goes to the small firms. They did this in connection with their tight money policies in the 1980's. I think there are other possible programs that would be more effective in insuring small business has an adequate supply of funds other than SBA, because SBA deals with less than 1 percent of the small business community.

Mrs. SNOWE. I know, Dr. Berney, that you mentioned in your testimony that you were speculating on what would happen if SBA would increase the guaranteed lending by 50 percent over 1981, it would make approximately 12,000 additional loans. But there is a twofold problem. One is obviously availability to small businesses; and second, there is the interest rate. I know that a lot of small business failures have been attributed to the fact of a lack of availability other than marginal because of the high interest rates, the high cost of borrowing money.

So, what good does it do a small business, for example—they can borrow money, as proposed on the guaranteed loan program, but the rate of interest is so high that it could throw them over the edge anyway? The prime rate is 16 percent. The guaranteed loan program, as I understand it, is 16 percent plus 2.5 percent.

Mr. LAFALCE. Roughly.

Mrs. SNOWE. Roughly. So many small businesses couldn't even absorb that high cost of borrowing. These programs are essential, but doesn't it have more to do in these business failures, the fact that the prime rate is so high?

Mr. BERNEY. It is a two-edged sword, one is availability and one is the cost. There is no doubt about that. If there is no availability at any price, then the small firm is really in trouble. But it is also true that continuing to pay these high interest costs in a period of weakening prices and falling demand is one of the big reasons why the small firm is being forced into bankruptcy. The small firm no longer has the expanding market conditions where he can pass these higher costs on to the consumer.

Mr. LAFALCE. There are just a couple of other points that I would like to make on that. First of all, if you cut the program back now for fiscal year 1983, and if you believe that we are going to be coming out of the recession, you are going to have an immediate pickup in demand. So if we are planning for fiscal year 1983 and the President says we are going to be coming out of the recession, you don't cut back the guaranteed loan program, because you

are going to need that authority to match the increased demand. That is point No. 1.

Point No. 2: One of the things the SBA has not done adequately—and it should in the future in order to deal with the affordability aspect of the problem, as opposed to the availability—is to engage in the education on and participation in creative financing techniques. Although banks might not be able to do this, if there is a guarantee there is no reason why the SBA and the bank can't get together and just have repayment on interest, as opposed to repayment on principal. There is no reason why the SBA, if it is guaranteeing a loan, can't encourage the private financial institutions to stretch out the maturity of the loan for a 6-year or a 7-year to a 15-year loan, as long as that guarantee is in place. It is invariably more secured than it needs to be. There is no reason why we couldn't balloon it at the end of a 5-year period or so to help the small businessman weather the storm during the recessionary times, in order to avoid the tremendous number of bankruptcies that we have in small businesses.

So it is not a simple question of just affordability. This is a serious problem. It is a question of the availability, and of markets—as is shown by the crowding out that is being done by the large business sector. It is also the creative use of the tools that are available within the SBA, which more often than not are not utilized by the overburdened loan officer who just wants to do his job as he has done it in the past, a lesser workload without being troubled by the niceties of creative financing. It just makes his job, and life, easier. We need greater leadership within the SBA urging this type of action.

Mrs. SNOWE. Finally, Dr. Popkin, you mentioned in your statement that, between 1972 and 1977, there was a significant drop in the ability of small business to create new jobs. Do you have any data or model that would suggest that if the Government would spend more money in programs such as SBA offering, would create more jobs as the end result?

Mr. POPKIN. The historical fact has been that small business has created the bulk of new jobs in the economy over the past 20 years. I see no reason to expect that that would change, because if my numbers correctly mirror the fact that small business is becoming less and less dominant a factor in capital-intensive businesses, then it is becoming relatively more labor intensive. That means that for every dollar generated in small business, you are putting more people to work than in the past.

Such evidence as there is suggests that small business might even be a more powerful job-generating tool in the future as the result of the decline in its capital intensity.

Mr. BERNEY. I think that is only a potential. The fact that bankruptcies are growing means that the small businesses aren't providing for job generation now. No one is providing the job generation now. That is the problem. That is why unemployment rates are growing larger and larger.

When we slip into a recession, more small firms are crowded out of the system. What job generation that occurs on a cyclical basis—versus a longer run basis—is probably either in Government—and they are cutting back now or in the large firm sector. But this is

just a very temporary cyclical thing. If we move out of the recession, the small business sector will be creating jobs as they have in the past, and we will get back to the kinds of statistics that Dave Birch has shown us, that the small firm is generating 60 percent of the net new jobs in the economy.

Mrs. SNOWE. Finally, and this is on a little bit of a different tangent, but what would you think of the idea of having a small business representative on the Federal Reserve Board?

Mr. BERNEY. We have never had one there. I think we need somebody there representing the small business sector. It bothers me that so many people who talk about being for business, don't recognize the difference between large and small business. Most of the policies that the Federal Government and other governments develop tend to benefit only large business and put small firms at a relative disadvantage. I think somebody on the Federal Reserve Board that is concerned about small business, that does necessarily mean that the small businessman, clearly would be a very useful addition to the Federal Reserve Board.

Mr. POPKIN. I am not so sure I go along with that. I remember the day we economists felt we were underrepresented on the Federal Reserve Board, and over the past 10 years, there has been an increase in the number of economists. I will leave it to you to decide whether that was a good thing.

Mrs. SNOWE. It is not a good time to ask that question.

Mr. BERNEY. That is true. Most of the new members are economists, and we don't seem to be any more effective at controlling the money supply or doing the other things that economists claim we are supposed to be doing.

Mr. POPKIN. I think that in the final analysis, it is an issue of congressional oversight, and just having one representative on a board like that isn't going to matter much.

Mrs. SNOWE. Thank you.

Mr. LAFALCE. I want to thank both of you very much for your fine presentations.

Now we will return to our representatives from the small business sector, and we will hear from both Mr. Harold Davis and from Mr. Peter Howell.

Congresswoman Snowe.

Mrs. SNOWE. Thank you, Mr. Chairman.

I would just like to say it is a great pleasure for me to introduce Mr. Peter Howell of Bridgton, Maine, who is here to testify today before the subcommittee on the proposed impact on small business if, in fact, we should cut back on the guaranteed loan program.

Mr. Howell's firm, Down East, Inc., was founded in 1973 and employs 30 people. It is involved in general fabrication, milling, welding and other machine operations. Much of Down East work is focused on manufacturing components for U.S. Naval vessels. I think, as Mr. Howell will tell you, Down East, Inc. probably would not be in existence today if it hadn't been for the SBA guaranteed loan program.

So I would like to welcome you, and I am sure that you can lend a very important perspective on the impact of the guaranteed loan program if it were cut back this year.

Thank you.

Mr. LAFALCE. With that great introduction, from, I might add, a great Congresswoman, we will call on Mr. Howell first.

PANEL CONSISTING OF CLARENCE "PETER" HOWELL; AND HAROLD E. DAVIS

TESTIMONY OF CLARENCE "PETER" HOWELL, PRESIDENT, DOWN EAST, INC., BRIDGTON, MAINE

Mr. HOWELL. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I welcome the opportunity to testify on the impact of the guaranteed loan program of the Small Business Administration. My experience over the last 18 years has left me with the belief that our tax dollars spent in providing the guaranteed loans to small business have the greatest benefit-to-cost ratio of any activity of the U.S. Government, and I don't exclude Congress.

My name is Clarence "Peter" Howell, and I am president and principal owner of Down East, Inc., of Bridgton, Maine. Down East has 27 employees and we are in the process of hiring 3 more. We have moderately sophisticated facilities for light and medium manufacturing. Almost all of our facility is presently directly related to defense. I would like to tell you of some of the ways that my companies have been helped by the SBA over the years.

I am a mechanical engineer. In 1961, I moved to Bridgton, Maine, to work for a local company. Three years later, my employer merged with a larger company and the Bridgton plant was closed.

My wife and I had bought a home in Bridgton, had small children, and did not want to follow my employer back to the metropolitan rat race. However, local employment opportunities for my skills were scarce to nonexistent. We decided to take our very limited personal resources of stocks and savings and start from scratch to build a company of our own, Howell Laboratories, Inc.

The startup of a new manufacturing company is expensive, and we knew that it would be. Our local bank was friendly and willing to help initially with several small short-term loans, but what was needed for stability was longer term financing. The bank was unwilling to provide this for a new untried company. My search for additional funding took me to the SBA office in Augusta, Maine. At that time, the SBA had a direct loan program for small business, and it was that program which provided the longer term financing that the new company needed and the bank could not provide.

In 1969, our company brought in additional stockholders and refinanced again with SBA aid. This time, it was an SBA guaranteed bank loan for a larger sum and a longer term. This enabled expansion and additional personnel.

Bridgton is a small town of only 3,000 people. Eighteen years have passed since we made the decision to stay there and form a company. I have since left Howell Laboratories and formed a second company. Today, there are two companies operating in Bridgton that employ almost 100 people. The 100 jobs described above would not exist today if we had not had the cooperation of the Small Business Administration and the guaranteed loan pro-

gram specifically. The economic impact of this program on Bridgton—which is largely tourist oriented—has been great.

In 1974, I organized Down East, Inc., and I now serve as its president. For the first 2 years, we employed eight people and supplied machine parts to a single, commercial customer. Financing was simple. The availability of prompt payment from our customer minimized our requirements for working capital. However, the recession of 1974 greatly reduced the demand for the product we were making. In order to survive, we had to find new markets. For a variety of reasons, we focused the restructuring of Down East toward manufacturing for the U.S. Defense Establishment.

By 1978, we had built our work force up to 40 people and shipments to $1 million a year. This growth was financed by short-term borrowing against specific contracts. Again, these borrowings were not available to us without the 90-percent guarantee of the SBA. If these guarantees had not been available, Down East would have quietly died in 1976 or 1977.

In May 1980, Down East received a loan from a local bank, a 10-year term loan for $350,000. The loan has a 90-percent guarantee by the SBA. We had to have the loan in order to continue in business. The bank did not want to make the loan, and the SBA convinced the bank to do so. It is now almost 2 years later and Down East has met all of its obligations in a timely manner. In our first full fiscal year after the loan, we shipped $1,100,000 and were nominally profitable. We are now in the third quarter of the second year, and we are projecting sales for the year of $1,300,000 with a modest profit. During this 2-year period, our interest expense has amounted to almost 7 percent of our gross sales.

We believe that we can double our employees in the next 2 years with a corresponding increase in our sales. We have adequate facilities, a skilled work force, and a solid supervisory staff. We have a rapidly increasing backlog of contracts to supply moderately complex products of the sort that we have extensive experience in manufacturing.

In my view, one of the positive qualities of the loan guarantee program is that it broadens the base of potential participants in private enterprise. It allows participation by a person who has the skills required, but does not have direct access to the financial resources needed.

I am impressed by the fact that the cost to the Government is limited to the administrative costs of the program. The borrower repays the loan and the interest charges. Why not consider applying that same principle to some of the other Government programs?

We are fortunate in Maine to have the SBA office staffed by people such as Tom McGillicuddy, Roy Perry, George Coffin, and Carl Sullivan. Their performance conforms to the highest standards of public service. I would like to add one thought in connection with—before I conclude—some of the questions. In my experiences in small business, we have to build a staff to do a job. We are at a point where we can, in effect, double our output without increase in our GNA staff.

You were speaking of the guaranteed loan programs and cutting it back, but you are not talking about eliminating the SBA. It

seems to me that the cost of this program is the administrative cost of the SBA. If you are going to cut the cost of the Government, you have to eliminate the whole program. So why cut out the guaranteed loan program? It isn't costing us as taxpayers anything anyhow.

Thank you very much.

Mr. LAFALCE. Very good.

[The prepared statement of Mr. Howell follows:]

PREPARED STATEMENT OF CLARENCE "PETER" HOWELL, PRESIDENT, DOWN EAST, INC., BRIDGTON, MAINE

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Bridgton is a small town of only 3,000 people. Eighteen years have passed since we made the decision to stay there and form a company. I have since left Howell Laboratories and formed a second company. Today there are two companies operating in Bridgton that employ between them almost 100 people. The 100 jobs described above would not exist today if we had not had the cooperation of the Small Business Administration and the support of their loan program. The economic impact of this program on Bridgton, which is largely tourist oriented, has been great.

In 1974 I organized Down East, Inc. and serve as its president. For the first 2 years we employed eight people and supplied machined parts to a single, commercial customer. Financing was simple. The availability of prompt payment from our customer minimized our requirements for working capital.

However the recession of 1974 greatly reduced the demand for the product we were making. In order to survive we had to find new markets. For a variety of reasons we focused the restructuring of Down East towards manufacturing for the U.S. defense establishment.

By 1978 we had built our workforce up to 40 people and shipments to $1 million a year. This growth was financed by short term borrowing against specific contracts. Again, these borrowings were not available to us without the 90 percent guarantee of the SBA. If these guarantees had not been available to us, Down East, Inc. would have quietly died in 1976 or 1977.

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Mr. LAFALCE. We will now hear from Mr. Harold Davis, president of Concentration Specialists, Andover, Mass.

TESTIMONY OF HAROLD E. DAVIS, PRESIDENT, CONCENTRATION SPECIALISTS, INC., ANDOVER, MASS.

Mr. DAVIS. Thank you.

I don't have reams of statistics with me today because I am here really as a small businessman, and what I want to talk to is really what the SBA means to me and has meant to me.

My name is Harold Davis, and I am president of Concentration Specialists in Andover, Mass. My company was started in 1976 and is one of those small, innovative research companies that is attempting to commercialize a unique technology. We concentrate food, chemicals, and industrial waste streams by freezing the water out, instead of the conventional method of boiling the water off. There are two major reasons for using freeze concentration as a process: One is that the process uses one-tenth to one-fifth the energy of the thermal evaporation process; and two, the flavor-bearing aromas remain in solution, which means that if you use freeze concentration to concentrate orange juice, you will get frozen orange juice that tastes like fresh orange juice rather than the current flavors we have today which are damaged by the thermal evaporation.

Mr. LAFALCE. Which kinds use the freeze concentration and which kinds use the other kinds?

Mr. DAVIS. Nobody uses freeze concentration. It was tried back in the middle 1960's, and was discarded because of high product loss. However, we have new technology that we think is far superior that will allow companies to economically use freeze concentration.

Our company employs 20 people, and over half of these are degreed engineers. It does about $1 million worth of business a year. During the past 5 years, our business has consisted of research contracts, at first primarily from the Government, and then, as we

more developed the technology, increasingly from commercial industry.

Our technology has now progressed to the point where I believe we can sell our first commercial plant this year. The commercial systems we sell will cost somewhere between $1 million and $2 million each. As we grow, I expect that we will have to turn to the venture capital market to finance these large sales, but it was SBA loans that got us to the point where we can consider this action on a reasonable basis. Eventually, I expect to be a $40 million per year company employing several hundred people.

My partner and I started the company with a lot of enthusiasm, energy, and $2,000. Needless to say, we quickly ran out of money, and this was during a period when venture capital wasn't available. Since my partner and I had always worked for large companies, neither of us had any previous experience dealing with the financial community.

Mr. LAFALCE. For whom did you work previously, Mr. Davis? What is your educational background?

Mr. DAVIS. I am a mechanica! engineer, and I have worked in the past at AVCO Systems Division in Wilmington, Mass. Prior to that I worked at the Fairbanks-Morse Division of Colt Industries. I was involved in freeze concentration programs that both those companies had. So this is not a new idea with us. I have been in it for over 15 years, and my partner has been in it over 20.

We got quite an education as we went about seeking money. Initially, we established a relationship with one of the area's largest banks. We went to discuss a loan with them and, after much paper pushing and many meetings, they decided they could not grant us a loan, even fully secured, that would be large enough to do us any good. After hearing the same story from several other large banks, we ended up at a small bank in Danvers, Mass., the Colonial National Bank, where we could actually talk to the president. He suggested that we look into the SBA guaranteed loan program, under which his bank would loan us the money, and 90 percent of the loan would be guaranteed by the SBA. In May 1978, we received a $60,000 loan under this program which was secured with personal property. Every payment has been made on time. Since that time, we have had several SBA contract loans secured by receivables assigned directly to the bank.

In my 5½ years of business, I have learned a great deal about banks and small businessmen. The first lesson I learned is that banks and the SBA are not a source of venture capital. The second is that big banks are not interested in small accounts unless you are so financially sound that you don't need to borrow the money in the first place. The smaller banks are interested in small accounts because they grow as you grow. The SBA is particularly important to the small bank because:

One, it allows them to spread their limited resources over a wider variety of opportunities.

Two, the maximum total amount of loans a bank can make to a single customer is around 1 percent of the bank's total capital. Since the SBA guaranteed portion doesn't count toward this total, the small bank can loan a larger amount of money to a single customer. This is vital when you are dealing with a small bank and

somebody who is really interested in you, because they can't go over this limit. The bank we are dealing with has assets of around $10 million or $12 million, which means that they cannot loan you over $100,000 to $125,000. There are times, particularly with receivable loans, that the need for money is far greater than that.

Third, they can sell the guarantees in the secondary market and increase their liquidity. Pension funds buy these because it is a very secure loan. However, the bank is still taking the risk with their 10 percent, as they agreed to.

Conversely, the SBA is important to me and my company because:

One, it permits a bank to become interested in me and my problems. All businessman will tell you how vital a working relationship with a good banker is to their business.

Two, it allows me to take larger contracts than we could with other forms of financing.

Three, our cash needs can be covered while we are waiting for payment. When you are doing a lot of Government business, you can wait a long time for payments sometimes.

Working with the SBA puts the small business on a more equal footing with the larger company which has far more resources and avenues of financing available. I will state uncategorically right now that we would not be in business if it weren't for the SBA guaranteed loan program.

I can't even begin to comprehend how our Government can consider cutting back this vital program. We have all seen the studies that show how important small business is to job creation, innovation and productivity in this country. How can we take away one of its few means of survival? This program is not a giveaway. The SBA only guarantees 90 percent of the loan. The loan is made by a bank at going interest rates and appropriate collateral is required. This seems to me to be a low-risk, low-cost method of helping people help themselves for the common good of the country.

Mr. LAFALCE. Thank you very much, Mr. Davis.

[The prepared statement of Mr. Davis follows:]

PREPARED STATEMENT OF HAROLD E. DAVIS, PRESIDENT, CONCENTRATION SPECIALISTS, INC., ANDOVER, MASS.

My name is Harold Davis and I'm president of Concentration Specialists, Inc. in Andover, Massachusetts. My company was started in 1976 and is one of those small, innovative research companies that is attempting to commercialize a unique technology. We concentrate food, chemicals, and industrial waste streams by freezing the pure water out instead of the conventional method of boiling the water off. There are two major reasons for using freeze concentration: (1) the process uses one-tenth to one-fifth the energy that thermal evaporation requires, and (2) flavor bearing aromas remain in solution which means that freeze concentrated orange juice would taste like fresh. The company employs 20 people, over half of them are degreed engineers, and does about $1,000,000 of business a year. During the past five years our business has consisted of research contracts, at first primarily from the government, and then as we developed more technology, increasingly from commercial industry.

Our technology has now progressed to the point where I believe we can sell our first commercial plant this year. The commercial systems we sell will cost between $1 and $2,000,000 each. As we grow, I expect that we will have to turn to the venture capital market to finance these large sales, but it was SBA loans that got us to the point where we can consider this action on a reasonable basis. Eventually I expect to be a $40,000,000 per year company employing several hundred people.

My partner and I started the company with a lot of enthusiasm, energy and $2,000. Needless to say, we quickly ran out of money and this was during a period when venture capital wasn't available. Since my partner and I had always worked for large companies, neither of us had any previous experience dealing with the financial community—we were in for quite an education. Initially, we established a relationship with one of the area's largest banks. We went to them to discuss a loan, and after much paper pushing and many meetings, they decided that they could not grant us a loan, even fully secured, large enough to do us any good. After hearing the same story from several other large banks, we ended up at a small bank in Danvers, Massachusetts, the Colonial National Bank, where we could actually talk to the President. He suggested that we look into the SBA guarantee program under which his bank would loan us the money and 90 percent of the loan would be guaranteed by the SBA. In May of 1978, we received a $60,000 loan under this program which was secured with personal property. Every payment has been made on time. Since that time, we have had several SBA contract loans secured by receivables assigned directly to the bank.

In my five and half years of business, I have learned a great deal about banks and the small businessman. The first lesson is that banks and the SBA are not a source of venture capital. The second is that big banks are not interested in small accounts unless you are so financially sound that you don't need to borrow money. The smaller banks are interested in small accounts because they grow as you grow. The SBA is particularly important to the small bank because:

(1) It allows them to spread their limited resources over a wider variety of opportunities.

(2) The maximum total amount of loans a bank can make to a single customer is around 1 percent of the bank's total capital. Since the SBA guaranteed portion doesn't count toward this total, the small bank can loan a larger amount to a customer.

(3) They can sell the guarantees in the secondary market and increase their liquidity.

Conversely, the SBA is important to me and my company because:

(1) It permits a bank to become interested in me and my problems. All businessmen will tell you how vital a working relationship with a good banker is to their business.

(2) It allows us to take larger contracts than we could with other forms of financing.

(3) Cash needs can be covered while waiting for payment.

Working with the SBA puts the small business on a more equal footing with the large company which has far more resources and avenues of financing available. I will state uncategorically that we would not be in business if it weren't for the SBA guaranteed loan program. I can't even begin to comprehend how our government can consider cutting back this vital program. We have all seen the studies that show how important small business is to job creation, innovation and productivity in this country. How can we take away one of its few means of survival? This program is not a giveaway—the SBA only guarantees 90 percent of the loan. The loan is made by a bank, at going interest rates, and appropriate collateral is required. This seems to me to be low risk, low cost method of helping people help themselves for the common good of the Country.

Mr. LAFALCE. About the only thing I can say is that I agree very strongly with both of you.

Congresswoman Snowe, any questions?

Mrs. SNOWE. Thank you, Mr. Chairman.

Both of you are certainly evidence of how important the SBA guaranteed loan programs are to small businesses. I gather from your testimony here today that the banks—did the banks state unequivocally that they would not provide or loan you any money without SBA guaranteed loans?

Mr. HOWELL. Yes.

Mr. DAVIS. In one case, the big banks weren't interested in providing a reasonable amount of money.

Mrs. SNOWE. At a higher rate of interest?

Mr. DAVIS. Even at any rate.

Mrs. SNOWE. Under any rate of interest.

Mr. DAVIS. Right. The second bank was big enough to meet our needs with the SBA helping them. Since that time, they have made us a few small loans without SBA backing, but those are very limited and very restricted.

Mrs. SNOWE. So the banks immediately rejected any offering of loans to you to begin your business?

Mr. HOWELL. Absolutely. There have been many occasions in the past 18 years when my ventures would have just gone quietly out of existence without the support. The banks would just not have done business with me.

Mr. DAVIS. Big banks are very conservative.

Mr. HOWELL. Small banks are, too.

Mrs. SNOWE. What is the attitude of the banks that you had to deal with regarding SBA loan prograns.

Mr. DAVIS. Well, the bank that I deal with does a lot of SBA programs and does a lot of dealing with them and feels that it is a very important part of the business.

Mr. HOWELL. They make more money on us than anybody else.

Mr. DAVIS. By the way, I have never paid prime. I have always paid below prime for my loans, which I think is interesting in this day and age.

Mr. HOWELL. I pay two above prime.

Mrs. SNOWE. Maybe you should look at his bank.

Mr. LAFALCE. You pay below prime including the guarantee fee?

Mr. DAVIS. Yes.

Mr. LAFALCE. Have you ever received an explanation from your bank as to how they were able to do that?

Mr. DAVIS. Because he sold the guarantees in the secondary markets.

Mr. LAFALCE. Very good. So he was able to recycle the money.

Mr. DAVIS. He was able to recycle the money and, in turn, build up his reserves and have more money to loan out again.

Mrs. SNOWE. That is it for questioning. I do want to thank both of you for coming here today and showing your willingness to testify on these programs. Thank you.

Mr. DAVIS. I hope it does some good.

Mr. LAFALCE. Very good, thank you very much.

The next witnesses will be from lending institutions. Arthur Mitchell is senior vice president of the Capital Bank and Trust Co., Baton Rouge, La.; and J. Knox McConnell, is president of the First National Bank of Keystone, Keystone, W. Va.

Mr. Mitchell.

PANEL CONSISTING OF ARTHUR J. MITCHELL; AND J. KNOX McCONNELL

TESTIMONY OF ARTHUR J. MITCHELL, SENIOR VICE PRESIDENT, CAPITAL BANK & TRUST CO., BATON ROUGE, LA.

Mr. MITCHELL. I am a little bit saddened that something that seems to be as important to small businesses doesn't get more attention and more people.

Mr. LAFALCE. So am I, that is why we are having hearings.

Mr. MITCHELL. When I was listening to your opening statement, I was sort of angry and upset, because I have heard these statistics

for 10 years. We have preached the gospel of SBA for 10 years, and we are still having to sit here now and fight to try to make it survive. We know that it does the most employing, it provides the most taxes and everything else. I just wonder how long we have to prove it before we leave it alone and let it do its job. I am not going to read the testimony you have, but I just want to go over some of the highlights and entertain questions.

Mr. LAFALCE. We will include the entire text of your prepared testimony in the hearing record. You may proceed to summarize it as you so desire.

Mr. MITCHELL. All right.

We have been involved in SBA guaranteed loans for about 10 years, almost since its inception. We have made approximately 435 loans, totaling about $70 million. About half of them were for new business, half for existing businesses. The applications asked for the number of jobs involved, so the statistics of jobs created or maintained is readily available. In our case, it was about 6,000 jobs.

Another statistic you will find in the testimony is that, our bank has about $206 million outstanding in commercial loans and, of that, about $34 million is in guaranteed loans. So you can see it is an important part of our portfolio. It is not something we treat as an afterthought.

In addition to the good things these loans do from a job creation standpoint and stimulation of the economy, they have been very good to our bank. These people, these small business people, keep substantial deposits with us far in excess of the 10-percent portion that we must maintain on our books, assuming that we do sell the guaranteed portion. Actually, it is virtually a perpetuating thing. For every $1 that we lend out, we really get $2.50 in deposits, counting only the portion again that we have to keep. So we can make all the loans we can get our hands on.

Our problem right now is the loan demand is down, primarily because of the economy and, of course, the interest rates. We are still prepared to make loans. It is just hard to find some that make good sense right now. We finance just about every type of small business that I know of, retail, some industrial, nursing homes, restaurants, a lot of service-oriented companies.

I want to mention again the impact of the jobs. We sent a survey out a few years ago to all of our existing customers and asked them to give us a current count of their employment. We got a substantial response back, and we found that those who responded were actually employing about 30 percent more people than they had anticipated at the time the application was made.

I think the statistics of the two gentlemen who were here before, would probably bear this out also because, as they, the small business grows, you automatically are going to add people to your payroll. So the increase in jobs is even more, I think, than the statistics that are available based on the application information.

The two businessmen that were up here a while ago made a point that they could not get financing without the use of SBA. We are a small bank, or at least I consider ourselves a small bank. Our problem is not so much with credibility because a bad loan is not made good by guarantees. You could guarantee 100 percent and, if

the loan is not good, it is going to default and everybody is going to lose.

Our problem as a small bank is liquidity. We cannot sit and make a 20-year loan for $300,000 or $400,000. We would be out of money in no time at all. Our source of liquidity is through the secondary market. If somebody walked in off the street and needed term financing, the savings and loans sure can't help them. They couldn't help them when they were healthy, so they sure can't help them now. The life insurance companies; they don't want to fool with anything that small. The only really other alternative is the banks, and we can't lend long-term with the kind of deposit structures we have. So, in almost every instance, this has been the mitigating thing that has made us go the SBA guarantee route. Although there is a greater risk in small business, there is no denying that.

Mr. LAFALCE. The secondary market gives you much greater liquidity. It also enables you to get a much higher rate of return. What does it do for your yield?

Mr. MITCHELL. I kind of hate to put that in the record.

Mr. LAFALCE. That is why I asked the question.

Mr. MITCHELL. If you use it, it makes it quite high.

Mr. LAFALCE. How high?

Mr. MITCHELL. Right now, I would say that you could probably sell the guaranteed portion and give an investor, at most, prime. So if you are, let us say, one over prime, then you are earning a 1-percent return on the 90 percent, coupled with your return on your 10, your actual investment of 10 percent would go way up. There is no question about that.

Mr. LAFALCE. Like what?

Mr. MITCHELL. Knox, do you have it ready?

Mr. MCCONNELL. 32 percent.

Mr. LAFALCE. So there is really a tremendous financial incentive to the banks to participate in the SBA guaranteed loan program. There is a tremendous financial incentive for them to give these loans at less than prime. I am sure that your bank, realizing this, must give loans at less than the prime; do you not?

Mr. LAFALCE. The key thing——

Mr. LAFALCE. Did you say "yes"?

Mr. MITCHELL. To make it less than the prime?

Mr. LAFALCE. Yes.

Mr. MITCHELL. If the secondary market can drop down. As big a figure as that is the 32 percent, that figure disappears unless you can put a spread in there. In other words, if the secondary market is at prime and we lend it prime, then we make nothing on the 90 percent, we make zero. So our yield then becomes only what we earn on the 10 percent. Do you follow me?

Mr. LAFALCE. Right. But since you are able to charge 2½ percent above prime, you can lend below prime plus the 2½.

Mr. MITCHELL. OK. The 2½ is probably excessive. I don't think there is any question about that. I think that is being addressed in other areas in the United States as to what the maximum rate ought to be.

But for the yield to be impressive, there has to be a spread of some kind between what an investor will want and what you can

charge. Now, if it needs to be 2½ over prime or 2¾ over prime, that may be excessive at this point. Although I think that when it began, it probably was good to have that much spread because investors were requiring much more than prime. This was a new program and they were wanting 1 over prime and 1½ over prime. The spread was considerably smaller.

One thing I want to clarify, too, and the statistics are real good, but sometimes misleading. We have heard people who have a negative feeling about the impact of SBA make the comment that very few banks use SBA. They come up with something like maybe 800 or 900 banks out of 15,000 really make use of this thing.

We are the most active bank in the State of Louisiana. We work with about 100 correspondent banks throughout the State.

Mr. LAFALCE. I was to speak at the Louisiana Bankers Association at your last meeting in Baton Rouge, except we got snowed in.

Mr. MITCHELL. I remember that. I was there to listen to it. But the point is that one bank—and we are not the only bank making SBA loans—but we could make and are prepared to make all the SBA guaranteed loans that need to be made in the State of Louisiana. The only reason I am pointing that out is because even though a lot of banks don't fool with them——

Mr. LAFALCE. At 32 percent, you would like to be the only bank making them.

Mr. MITCHELL. That is right. We will take all that we can get.

But the point is that, even though a lot of banks don't make use of SBA, the small businessman, in most cases, is having access to a bank who does. It is not like the program is just being discarded by most banks.

Incidentally, I don't understand—and I have shared these yield figures, and I am sure Knox has, too, in many seminars we have done with SBA to bankers. I have spoken to the ABA groups, the IBAA groups, and we have laid it out on the charts and said, "This is what you can do." I don't understand why they don't participate more, I really don't.

But, for some reason, they don't. I can speak for Louisiana that anybody in that State that needs a guaranteed loan can find it, even though a very small percent of the banks there are actually participating in the guaranteed loan program.

Also, something else that needs to be said is that the SBA guaranteed loan program has often been unjustly maligned because of the availability only of negative statistics. It is really easy to find out those businesses who fail. There are virtually no statistics available for those who succeed. It is kind of sad because the only thing people read about or hear about are how many failures there have been and how much loss there could have been involved in those things.

I want to touch on just three cases that we have—and I won't read the whole presentation—but some of the key factors. We have one company, Scaffolding Rental & Erection Service, which is a subsidiary of what initially started as ANCO Insulation Inc.

In 1967, they formed a subsidiary and incorporated with an $86,000 net worth. We obtained for them a 5-year $300,000 SBA loan secured by equipment, scaffolding, and the endorsement of the

principals. At the time the application was taken, they had 34 employees. They felt that this loan would let them bring the employment up to 40. Last year, they had a payroll of $15 million or $16 million. They had 800 employees, and gross sales of $33 million. They paid over $2 million in State and Federal income taxes and another $500,000 in local sales tax.

Again, this company has far outreached its need of SBA, but it was an SBA loan that got them started. The byproducts of this company are helping, as far as I am concerned, to pay for the administration of the SBA program.

Golden Harvest Corp. was a business where two ladies went into the nursing home business. We made them their first SBA loan to purchase an outdated nursing home and do some remodeling. From there, we made them several SBA loans. At present, they own three nursing homes, they went from 52 beds to 417 beds, from 35 employees to 300 employees, and from revenues of $237,000 to $4.4 million.

Sergeant Ed Buggs was a retired black sergeant from the Army. He had been turned down by several banks when he wanted to go into the grocery store business. We made him an SBA loan. He started out with 4 employees, now he employs over 10 people; he has two stores; and his sales last year were over $2 million, or right at $2 million.

The program, as it is designed, as far as I am concerned, is about as perfect as you could make it. We have learned to work with SBA. We have learned the requirements they have. We have learned how to work together with them. I can say, without exception, having dealt with other legs of the Government, that the SBA people are probably the easiest to work with as far as being real people then anybody that I have ever met.

I feel that at Capital Bank, we have given the SBA program a thorough utilization for over 10 years now. We are convinced today more than ever before that it is one of the finest instruments to come out of Washington that can benefit so many at so little cost.

Some of the problems that are evolving that I just wanted to touch on briefly that are not in the written testimony: For the last year and a half, every time we picked up a paper or picked up a letter from the IBAA or the ABA, there has always been a threat to SBA, either a threat to do away with it completely, a threat to cut back tremendously on its budget approvals. One thing that that has caused in the New Orleans SBA office is that they have lost just about all of their key, top staff people. They have lost four men that I know of personally who were the heart of their staff, because of the uncertainty of whether or not there is going to be an SBA. These people have all left SBA and taken jobs out in the private sector.

In each case, it was because of the uncertainty of their future, whether there would be an SBA, whether it would be viable. It is really disrupting, that the whole concept of SBA—this is something that is not going to show up in statistics—but if this economy goes back up, if there is a large loan demand, I am not sure but that we are going to suffer greatly from these offices, and I have a feeling that New Orleans is not the only one that is going to be very

poorly staffed, and we are going to have to start all over again beefing up these offices to make them as viable as they ought to be.

I would like very much if we could—SBA is one of the few things that works—if we could just leave it alone and let it do its thing.

That is about all I have to say. Thank you.

Mr. LAFALCE. Thank you very much for your testimony.

[The prepared statement of Mr. Mitchell follows:]

PREPARED STATEMENT OF ARTHUR J. MITCHELL, SENIOR VICE PRESIDENT, CAPITAL BANK & TRUST CO., BATON ROUGE, LA.

I would like to express my appreciation for allowing me to share with you our excellent experience we have had using the SBA Guaranteed Loan Program. Since our involvement with the program approximately 10 years ago, we have made 435 loans totaling $69,973,030. The make-up of these loans was approximately 50 percent for new business and 50 percent for existing businesses. The jobs created or maintained as a result of these loans was 6,038. As of March 19, 1982, our total commercial loans outstanding was $206,000,000, and our SBA loans outstanding was $34,000,000.

It is difficult to ascertain accurate statistics as to exactly what our involvement with SBA has meant to our bank in terms of new business and profits. However, some information we do have is that based on an analysis made a few years ago of all our SBA loan customers, we found that the average deposits kept in our bank by them was slightly over 25 percent of the total outstanding loans. Bearing in mind that we view the guaranteed portion of the SBA loans as a completely liquid asset, due to the constant availability of secondary market buyers, it is evident that the deposits in our bank from SBA customers exceeds the 10 percent unguaranteed portion, which is our absolute investment, by one and one-half times. In other words, for every dollar we invest in SBA guaranteed loans that were not saleable in the secondary market, we received two and one-half dollars in deposits. This was accomplished even though compensating balances cannot be made part of the loan covenants. We have always found that the small business borrower was so grateful to receive the loan, which in all cases was not obtainable through normal sources, that he was more than happy to keep accounts with our bank. We have also found these customers to be most loyal as to deposits and users of other bank services. I might add that a number of customers who started out with SBA loans have long since paid these loans off, but continue to keep substantial balances with our bank.

With the combined account balances mentioned above plus the attractive interest rates on the loans, and the excellent secondary market sources available, I can say without hesitation that the SBA Guaranteed Loan Program has been a most profitable venture for our bank and has been one of the most important factors which has contributed to our growth in a community where banking is extremely competitive.

As to types of small businesses that we have financed: We have financed everything from nursing homes to industrial construction to retail establishments, restaurants, and service orientated companies.

As mentioned previously, the jobs involved in the loans we have made total 6,038. Sometime back, we wrote all customers who received an SBA guaranteed loan and asked them to give us the actual number of employees they had working as of the date of the questionnaire. Ninety-four of the customers responded indicating the number of employees to be 1,596. We went back to the initial applications and found the number of employees for these ninety-four customers at the time of making the SBA loans was 1,259. This was a 30-percent increase since the inception of the loans. Based on this survey, I feel it is safe to say that there have been well over 7,000 jobs involved with these loans Capital Bank & Trust Co. has been involved in. We feel this is extremely significant at a time when employment is so critial to our economy.

Some other points I feel are important to keep in mind is that without use of the SBA guarantee we would have been unable to make the loans we made due to the length of time requested for repayment. The terms needed were longer than we could justify as a commercial bank where liquidity is such a crucial factor.

Also, although these loans were underwritten with as great a care as possible, it is common knowledge that failures of small businesses, especially those starting up, is extremely high. It would have been impossible for our bank to make the amount of loans we have made without the backing of SBA.

Something else that should be kept in mind is although a relatively small number of banks participate in the SBA Guaranteed Loan Program, I believe that this small

number is capable of meeting all the needs of prospective small business borrowers who need the SBA guaranteed loan.

In our case, we have been one of a very small number of banks in the state of Louisiana who has been active in making SBA guaranteed loans. By working with downstream correspondents in the state, we have been able to make SBA loans not only in Baton Rouge, but throughout the state of Louisiana. I feel it is accurate to say that through this system, we have made, and continue to make SBA guaranteed loans to anyone in the state of Louisiana. I make this point to show that even through a fairly small number of banks are active participants in the SBA program, I believe that all small business interests are being served and have access to this excellent and needed source of financing.

Something else that needs to be said is that the SBA Guaranteed Loan Program has often been unjustly maligned. For each reported failure (and these statistics are readily available) there are hundreds of thriving, healthy businesses which were launched by the SBA Guaranteed Loan Program, but have no way of being counted as offsetting statistics to failures. As an example of some of these successes, we would offer the following three case histories:

Case No. 1: Scaffolding Rental & Erection Service, Inc.

In 1962, R. L. "Sonny" Anderson put his faith and his money in the insulation business, and the result was Anco Insulations, Inc. As the business grew and expanded, a need for specialized equipment developed, and one of the offshoots of the main enterprise was a scaffolding operation.

In 1967, it was determined that a successful subsidiary business could be established to rent and erect scaffolding equipment, and the company was incorporated with a net worth of $86,000.

In 1969, despite a temporary recession in the Baton Rouge construction industry, it was decided that the scaffolding business could be expanded to handle construction contracts. Financing the business was becoming increasingly difficult because of the nature of the equipment. The scaffolding could not be identified by serial number and was moved frequently from one location to another. Thus, it did not lend itself to a conventional chattel mortgage or other evidence of collateralization. Each request for additional financing met with more pronounced reluctance to lend and with stronger demands for more security.

At this point, because of circumstances unrelated to the scaffolding business, Anderson moved his financial dealings to Capital Bank & Trust Co. When he discussed with our bank the problems he had encountered in seeking conventional financing for Scaffolding Rental, the idea of obtaining an SBA loan was born. After the application process, a five year loan of $300,000 was approved—secured by new equipment to be purchased with the proceeds, second mortgages on some real estate, and the personal endorsement of Sonny Anderson.

At the time of the SBA application, Scaffolding Rental employed six persons. The approval of the loan made possible the addition of 34 employees, bringing the total to 40. The expansion was well timed; by 1972, the local economy picked up, and building permits hit a new high—more than double the 1969 rate.

Scaffolding Rental & Erection Service, Inc., now meets total payrolls of $15 million—$16 million a year, covering more than 800 employees. Gross sales last year exceeded $33 million, and the worth of the company is appraised at $7.1 million. Over the last two years, the business has paid approximately $2 million in state and federal income taxes, plus 1980 local and state sales taxes of $500,000. Demand balances in our bank for this company alone average well over $500,000.

Case No. 2: Golden Harvest Corp.

Helen Pope and Barbara Stephenson were both reared in homes in which self-employment was a generations-old tradition.

The daughter of successful retail store and garage owners, Helen grew up with an awareness of the hardships and rewards of a business career. Having attended high school, college, and business school, she became assistant manager of the family business, of which she was part owner. During this time, she launched her own business ventures as owner and manager of two apartment complexes in her small hometown.

Barbara's parents were also self-employed, and it was the exposure to this environment which nurtured her future business aspirations. After high school and business college and some secretarial work, she accepted the responsible position of tax collector in her small town. It was during this period that Barbara overcame the formidable obstacle of obtaining financing to build and manage two other apartment complexes. She was simultaneously active in the insurance marketing field.

Thus, the spirit of entrepreneurship was thoroughly ingrained in each of the women before they got together in 1969 in Denham Springs, Louisiana (about 15

miles from Baton Rouge) to buy an existing, though outdated, nursing home. By 1971, it was clear that expansion and renovation would be necessary to maintain high quality patient care and growth of the business.

The partners became aware that the owners of another facility nearby, the Golden Age Nursing Home, were experiencing difficulties because of the poor health of one of the owners. A large amount of capital was required for the proposed acquisition, and the assets of the partnership were already "mortgaged to the hilt", as Barbara remembers.

As Helen and Barbara met with turndown after turndown from conventional sources for financing, they became discouraged and nearly settled for the status quo. Something kept them searching, however, and Helen recalls: "We just couldn't be satisfied with standing still—we wouldn't take no for an answer."

The solution to the problem came when Barbara saw a newspaper ad featuring the availability of SBA funds at Capital Bank & Trust Co. The two women agree that this was the turning point in their business.

An SBA guaranteed loan of $220,000, obtained from Capital Bank, made possible the purchase of the Golden Age Nursing Home. Soon after, a second loan—funded by Capital Bank and guaranteed by SBA—was made to expand the number of beds available.

So the business which began with one location, 52 beds, 35 employees, and $237,000 revenue in the first year has grown through a combination of good fortune and the business acumen of the partners. Today, there are three nursing homes containing 417 beds and employing more than 300 persons, with annual revenues totaling more than $4.4 million.

Case No. 3: Sarge's Grocery & Market.

Sergeant Ed Buggs retired from the Army in 1972 and returned to his home in Baton Rouge with a wealth of ideas about managing people, supplies, and business. A man accustomed to giving orders, he dreamed of owning his own business, supporting his family, and serving in his community.

However, he had several strikes against him from the financial community's standpoint. He had no capital to invest and no track record as an independent businessman. And, even more significantly, he was a black man returning to a city in the throes of conflict over integration, segregation, and equal opportunity.

In this unstable atmosphere, "Sarge", as he is still called, was turned down all over town in his search for the financing of his own grocery store. It was not until he happened to call on Capital Bank & Trust Co. that a glimmer of hope began to shine. The bank introduced him to the SBA guarantee program and, within a relatively short time, he borrowed enough to build and stock the grocery store he dreamed of.

Sarge, who started out with four employees, has since added a second store and ten more employees. His gross sales last year were close to $2 million, and his deposit balances in our bank are in keeping with a successful retail business of this size. The original SBA loan has long since been paid out, and Sarge is a good commercial customer.

In conclusion, it is my belief that the SBA Guaranteed Loan Program is one of the greatest assets to placing monies in the hands of qualified small business people and do it in a manner that, if done properly by cooperative banks, can be done at very little or no cost to the Government. I believe that the guarantee fee paid by the borrowers plus added employment, additional taxes, and general positive input by those strong, healthy small business concerns will more than offset those losses by those businesses that fail.

I feel that we at Capital Bank & Trust Co. have given the SBA Guaranteed Loan Program a thorough utilization for over ten years, and we are more convinced today than ever that it is one of the finest instruments to come out of Washington that can benefit so many at so little a cost.

Mr. LAFALCE. We will now hear from Mr. J. Knox McConnell, president, First National Bank of Keystone, Keystone, W. Va. I believe he is, in a sense, representing not only his bank, but also the IBAA. Is that correct?

TESTIMONY OF J. KNOX McCONNELL, PRESIDENT, FIRST NATIONAL BANK OF KEYSTONE, KEYSTONE, W. VA.

Mr. MCCONNELL. Yes, sir.

Thank you, Mr. Chairman. It is a pleasure to be with all of you today.

I would just like to concur with my colleague to the left on his remarks. I think they were very well put. Essentially, we operate pretty much like their bank, although their bank is much smaller.

I think today I am going to give you an interesting input into what a small bank in a town of 800 people has done which, in some parts, is considered amazing in the State of West Virginia. We owe everything that we have done to the SBA program.

First of all, 5 years ago, the bank was a $12 million bank and going downhill, primarily because of West Virginia banking regulation. This is a unit banking State, with no branch banking available. As a result of that, the bank was getting crowded by old management, and it was just getting crowded in general. As a result, a new attack had to be launched or the bank was not going to survive. Today, the bank is almost $30 million, in a period of 5 years going from $12 million to $30 million, in an economy that really has not grown that fast in West Virginia. We owe this primarily to the SBA program.

Just a few statistical remarks about our area: Our bank is located in the southernmost part of West Virginia, in McDowell County. This county has an abundance of metallurgical coal. The coal is sold throughout the world, primarily the markets are Japan and the Netherlands. Our area is a one-industry area, and coal is of primary importance.

I came to that area with several other people about 5 years ago, and we saw that we were losing people to other parts of the area. When you do that, you certainly lose the input of taxes and home building, and so on. In October 1977, the board of directors and management of the bank launched a program that has had great effect. We initiated a small business lending program and in a 10-month period, we generated $3 million worth of SBA loans.

Mr. LAFALCE. I am a bit confused. You said in 1977; yet, you are speaking exclusively of this 10-month period. I take it this is a recent 10-month period.

Mr. MCCONNELL. No, it appears to be that way, but it isn't. In a 10-month period, we made $3 million worth of——

Mr. LAFALCE. That was following October 1977?

Mr. MCCONNELL. In October 1977, and 10 months forward of that period, we made $3 million worth of SBA loans.

Mr. LAFALCE. I see.

Mr. MCCONNELL. These were disbursed in the first 10 months. What that did for our area—and that was done basically within our area—was that it gave added employment to the area, it applied capital to business, and $2.7 million of that money was put back on the secondary market through investment bankers so that we could recapture the money and relend the money all over again. It is interesting, from this standpoint, that in a period of 22 years, the whole county of 50,000 people had only made five previous SBA loans. We feel that we generated a great deal to the area.

One of the reasons that the SBA program has been so vital to our bank is—one of the gentlemen who had testified before had made this comment—our bank can only lend $200,000 to any one individual or one corporation. But with the aid of the SBA, we

were able to go actually to $500,000, the guarantee limit. We really can lend $550,000 to any one borrower. That gives us a tremendous leverage. A small bank is now able to get big bank status from the standpoint of lending.

We think that the main thrust of the SBA program has been to keep businesses viable in our area and keep our people in our area. In reality, the small businessman often uses banking institutions as the lenders of last resort—I think this is so important for this committee—simply because he is not sophisticated enough to go to the open market and expand his borrowing. He really doesn't know to much about borrowing per se.

I have a few documents here, that I am going to leave with you for entry into the record, of some of the things that we do. These include holding clinics twice a year and giving input to the small businessman from the standpoint of what money is all about. Very few people are sophisticated in the money business in the small business area. They are when you get to General Motors or Ford Motors and people of these magnitudes, but not when you get with the smaller businessman. We believe that we also have to not only use SBA as a tool, but we also have to educate the small businessman in what business is all about.

We believe that our bank must preserve the small businessman, or ultimately, as we have talked about it before, this morning, larger corporations could take over. And, as we all know, 98 or 99 percent of the businesses in this country are really affected by what happens to the small businessman.

Another thing that was interesting as we sat down and charted our course for the small business program was to look at West Virginia in general. By the way, we take West Virginia as our lending area, the whole State of West Virginia. There are 1,800,000 people in West Virginia. We will make an SBA loan in any part of West Virginia, not just southern West Virginia.

In our opinion, we think the SBA is one of the greatest programs the Government has ever put together. It has been abused in some instances. But, in general, I think it has been a great, great tool. By the end of 1982, we will have processed over 50 SBA loans for a total volume that I would say would be in excess of $6 million. That is pretty good for a bank our size in our area. We are considered—in West Virginia, anyway—the leader of SBA loans. There are only 5 banks out of 235 banks in the State of West Virginia that are active in SBA loans. We are the most active of those five banks.

I am going to skip over some things. If you care to, you can ask me any questions you want. But as I sit here and think about cutting the program back, if we cut out two aircraft carriers out of our budget, we could keep the SBA afloat. I think that is a pretty interesting idea because we are not here to talk about nuclear holocaust.

Mr. LAFALCE. We wouldn't have to do that because we are talking about guarantees.

Mr. MCCONNELL. I think it is, in a way, worth repeating.

I have often wondered myself why more banks don't get involved in SBA lending. I believe it is due in part to what is considered a voluminous amount of paperwork. So we try to eliminate that

paperwork. As far as I know, we are the only bank in the country that does this to any degree.

I went to the president of a small college that is 30 miles from our bank and I talked him into the idea of putting a three-credit course called Small Business Institute into his college. We would send the customers up to the college where the students, the senior students in their last semester of college, would package, program, and present to our bank these SBA loans. At the same time when they presented these loans, they would also evaluate the loans as to whether they thought the loan was a good or bad loan. As a result, we have made very few bad SBA loans. Like Arthur, I have probably never made a bad loan in my life; they go bad after you make them. But we have had very few bad loans as a result of it.

What we have been able to do is the college students, through the college professor who is the head of this department, they underwrite the loan, then we underwrite the loan, and then the Small Business Administration underwrites the loan. Generally, you don't get all three bad. As a result of it, it has been a great program. It is also very cheap for the customer to do it this way. The small business loan package, there is a charge on it of $100 by the college. Then we give the college a stipend of $100 for their work. It is still much, much cheaper to do it that way than to have a certified public accountant do it, which would cost probably $600, $700 or $800 just to package up a loan request, or to give an attorney the package to do it, because he would have to charge a lot of money. But we are able to do that at a direct customer cost of only $100, and we match that with the college.

The students then stay with that loan. Once it is granted, the students stay and live with that loan until they graduate from college, which gives the student an insight into business other than just a textbook insight. It has just been a tremendous program. In fact, 2 years ago, we hired a young man who now heads up our business department, or SBA department, just because of the input that he put into SBA loans and how much he liked putting them together. We thought that we had a gem in an individual if we would hire him; we did, and he has just done a beautiful job.

I have recommended this to many schools. I have recommended this to many banking groups. There isn't any other group that I know that does this. They don't do it in our neighboring States of Ohio, Virginia, Pennsylvania, or Kentucky. I don't know of any group that will organize themselves with a bank, and a college, and an SBA program to put it together.

We also put together a cassette set, a tape that runs 10 minutes that I show to various service clubs: Kiwanis, Lions, Rotary, PTA, whatever. This 10-minute program discusses the SBA loan and how you go about getting an SBA loan. We have the SBA speak, we have the college professor speak, and I am also on the tape discussing it from a banker's standpoint. So, as a result of it, it has been a very viable program for our bank.

The bank, when we were $12 million, made very little profit. Arthur will appreciate these figures. It made less than one-half of 1 percent on assets. Our bank now makes almost 2 percent on assets as a result of the SBA program. We could not get along, our bank could not exist, without the SBA program. You can't make mort-

gages today with the rates of interest. The mortgages are out. The mortgage business has really dried up. The only thing left, with our concept of business, is the SBA program. That is why we have expanded it up into the whole State of West Virginia.

In conclusion, I would just like to say that representing the independent bankers and also the banking fraternity in general, I would say that we just can't permit these programs to be cut; we just can't permit it. It would do a great disservice to the small businessmen. We are the lender of last resort in many cases. I would like to share the same comment that Arthur did, that we are with a good group of people in West Virginia that are handling these SBA loans. They are dedicated people. I have never worked with a greater group of people in my life than I have with the small business people in West Virginia.

I can't say that when it comes to the regulatory authorities, such as the Comptroller of the Currency. We are in a battle with him all the time. But we are not when it comes to the SBA. They work with us, they have a feeling for us.

Summing things up, I would like to mention that in the 5 years we have been in this business, we have won an award four times as a result of our outstanding work with the small business industry, and I believe that we will win an award again this year.

Thank you very kindly.

[The prepared statement of Mr. McConnell follows:]

PREPARED STATEMENT OF J. KNOX MCCONNELL, PRESIDENT, FIRST NATIONAL BANK OF KEYSTONE, KEYSTONE, W. VA.

Mr. Chairman, it is a pleasure to come before this Committee and I welcome most sincerely this opportunity. Our Bank is located in the southern most part of West Virginia, in McDowell County. This county has an abundance of excellent metallurgical-type coal, which is sold throughout the world, including Japan and the Netherlands. Our area is a one industry area. Coal is of prime importance to this area. Our institution, which has approximately $27 million in assets, is dedicated to the preservation of our community and county.We are vitally interested in having residents stay in our community and not migrate to other areas. Once people migrate, the community loses esential tax funds and purchasing power.

In October of 1977, the Management and Board of Directors launched a program that has had great success. This was initiating SBA lending through The First National Bank of Keystone. To date, we have granted and disbursed approximately $3 million in a ten month period. This constitutes thirty loans. The impact is related in this manner: (A) We have additional employment; (B) capital was applied to these businesses; and (C) $2.7 million of the capital came from outside sources on the secondary market.

What we do, Mr. Chairman, is once a loan has been approved and granted, we sell 90 percent of the guaranteed portion to the secondary market. This gives the bank an opportunity to continue to re-lend. In a period of twenty-two years, approximately five SBA loans were made in McDowell County. In a period of ten months, this institution has disbursed or committed on fifteen loans in our county and fifteen loans in the counties contiguous to our county.

Our legal limit is $200,000.00 to any one company. With the aid of SBA, we are able to grant loans up to $500,000.00. We are dedicated to helping businesses employ additional people and to keep businesses in our area. The SBA is our partner in this program.

In addition to this, Mr. Chairman, prior to our activity with SBA, many of the mine related businesses were forced to seek financing out of this area. As a result, money would flow out of our area and never return. Now, we have been able to inject back into our area $2.7 million.

Service businesses such as certified public accounting firms, and insurance companies are adding employees to service areas that require the above type of services;

therefore, all areas of business benefit. Jobs are the answer to a prosperous economy.

In reality, the small businessman often uses our banking institution as the lender of last resort, simply because he is not sophisticated enough to go to the open market and expand by borrowing, as do the large corporations. We have an unusual thing in West Virginia. I believe we are one of ten states whereby more production is generated by larger businesses than by the smaller busineses. We believe at our bank that we must preserve the small businessman, or, ultimately, the majority of production could go to larger companies—and, quite possibly, the top 100 or 200 corporations in the country. Also, our bank firmly believes that SBA loans help to establish various types of businesses unrelated to just one major industry.

As you know, West Virginia is predominately known for its coal. States and areas that have permitted one industry domination eventually decay—this is so true particularly in and around the area of Detroit.

In the opinion of our bank, the SBA is one of the greatest government entities ever created. By the end of 1982, we will have processed approximately fifty SBA loans for an over the dollar value of about $6 million. We think this is tremendous from the standpoint of generated jobs and productivity. I estimate that we have helped to create 150 additional jobs through our SBA program.

One of the things, Mr. Chairman, that I particularly like about the SBA is the fact that we are not, at our institution, giving money away. This is not true of many governmental programs. Customers pay a normal rate of interest for this service and for the money. As we all know, it would be easy to create a governmental body and just give people money, but I am sure many of you sitting here today would not permit give-away programs, as they have appeared in the past. Also, when a person receives an SBA loan, they pay a guaranteed fee to the federal government—which is additional income to our great government.

I cannot speak too highly for this program, and it is my opinion and desire that the guarantee program within the SBA should not be cut back. I think it would do a great dis-service to this fine country. I do believe tighter guidelines can be set up and a follow-up system adhered to. The reason I say this is due to the fact that we have had (not at our institution) instances where loans have been granted without fiduciary responsibility, and I think we could improve on better underwriting techniques. I appeal to you, do not cut the guarantee of the SBA.

This program, Mr. Chairman, is viable and objective, and I can tell you this, our little bank in Keystone, West Virginia, wishes to be the "corner-stone" of this possibility.

Mr. Chairman, our bank has a very unique way of processing SBA loans and I recommend whole-heartedly that this program be adopted throughout banks and institutions of higher learning. Mr. Chairman, let me tell you about our program. The First National Bank of Keystone participates heavily in the Small Business Administration program. The First National Bank is one of the leaders, not only in the State of West Virginia, but in the United States, in the processing of SBA loans. The philosophy of this bank is to be a "partner-in-progress" within the community, our county, and the great State of West Virginia.

The First National Bank of Keystone has a unique way of processing SBA applicants. The bank sends the applicant to the office of the Center for Economic Action, Concord College, Athens, West Virginia, and that office does the processing of the package. The package is then sent to the bank for review. Every Wednesday morning, the First National Bank's Executive Committee, which constitutes Mr. Julian G. Budnick, Mr. J. Louis Pais, Mr. Paul B. Miller, and I, review these loans. Once the loan is approved by the Executive Committee, I contact the applicant and make an appointment with the applicant and the SBA office. I bring the applicant and the SBA face to face with each other.

Once the applicant turns over all pertinent information, and has this packaged by the Center for Economic Action, the SBA processes the loan—usually, within two weeks. Once the loan is approved by the Small Business Administration, and provided the applicant has met all of the requirements set forth by the SBA, the loan is then ready for funding. The average length of time for an applicant to receive money is about twenty days from the date made with the Center for Economic Action for packaging of the loan.

In the 1978 February issue of the Banking Magazine, an article on the above process was printed—which went national to all banks in the United States.

Also, March of 1982, an article (which is attached) appeared in the Independent Bankers Magazine which describes the honor that The First National Bank of Keystone received from Concord College, Athens, West Virginia, for its contribution to the SBA program. In 1978, 1979, and 1980, the SBA honored the First National

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Bank of Keystone, and in 1981, the Center for Economic Action, Concord College, bestowed its highest honor on our institution. Every year since the First National Bank of Keystone initiated the SBA program, its staff has done a magnificent job.

Mr. Chairman, it has been my pleasure to address your great body and I bring a message from our Board of Directors, management and staff, that we will give you and your Committee our 100 percent support.

[From Banking Magazine, March 1982]

BOXER AND BANKER: LIFE LONG FRIENDSHIP

Late last year, The First National Bank of Keystone, Virginia, was singled out for its contributions to businessmen in southern West Virginia. It was the fourth consecutive year the bank had been so honored, somewhat of a record, we would think.

In the previous three years, it was the Small Business Administration that was handing out the accolades. The most recent bouquets came from the Center for Economic Action, a division of Concord College, Athens, West Virginia.

Not only was this award somewhat different from earlier honors, but it also revealed what a significant influence a former prize fighter has had on the life of J. Knox McConnell, president of First National.

For at an awards dinner sponsored by the Center to honor Knox was Billy Conn, former light heavyweight champion of the world. He was there as McConnell's guest and proved to be an inspiration to those attending the banquet. Billy established a few records of his own: losing only three of 77 professional fights, seven consecutive wins in the ring at Madison Square Garden, wins over 21 world champions.

Knox McConnell was eight years old when he first saw Billy Conn fight. From that time, Knox never missed a Conn fight and a friendship began that was to help shape the bank president's life.

According to Knox, Conn taught him a great deal about compassion as well as helping him enjoy a vitality in life. When comedian Bob Hope heard of Conn's appearance at the banquet, he sent Knox a telegram in which he described Conn as "A model for all fighting Americans."

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THE BANKING SYSTEM: MONEY & CREDIT

"YOUR PARTNER IN PROGRESS"

FIRST NATIONAL BANK OF KEYSTONE
Main Street Keystone, West Virginia 24852

At this workshop you will

- Learn "how to" procedures for determining financial requirements
- Understand some of the language of finance
- Recognize obligations to conform to state, local, and Federal tax laws
- Recognize the importance of records
- Determine if you have the personal characteristic factors to run a business
- Learn the major local, state, and federal business taxes

* You will also be afforded the opportunity to ask questions - index cards will be provided for your use in jotting down any questions which you would like to have answered.

Starting and Managing A Small Business is Sponsored by:

First National Bank of Keystone

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Small Business Administration
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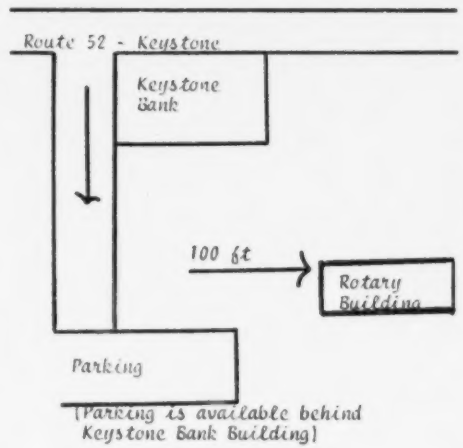
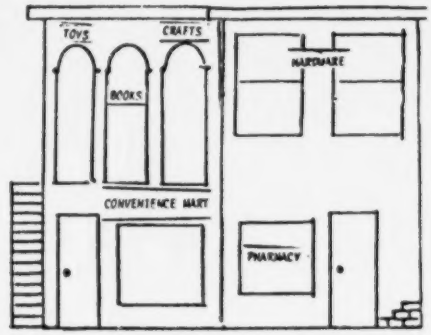
STARTING AND MANAGING

A SMALL BUSINESS



[Parking is available behind Keystone Bank Building]



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STARTING AND MANAGING A SMALL BUSINESS

October 13, 1981
9:00 a.m. - 2:00 p.m.
Keystone Rotary Building

THE PROGRAM

Starting and Managing a Small Business is a workshop designed for those persons desiring assistance in the management or startup of a small business.

The speakers have been chosen because of their expertise in the field and their experience with small business.

AGENDA

A. M.	
9:00-9:30	Registration
9:30-9:45	Welcome
9:45-10:30	Personal Factors & Evaluation
10:30-10:40	Break
10:40-11:20	Regulations, Taxes, Insurance & Business Records
11:20-12:00	WV Journal Video Presentation Financial Factors
P. M.	
12:00-1:00	Luncheon - Buffet Host - First National Bank of Keystone
1:00-1:45	General Discussion
1:45-2:00	Management Assistance & Workshop Evaluation

WORKSHOP SPEAKERS

Your speakers for the workshop include:

Mr. J. Knox McConnell
President
First National Bank of Keystone

Ms. Billie Cherry
Cashier
First National Bank of Keystone

Mr. Michael Graham
Certified Public Accountant
Richlands, Virginia

Ms. Sharon Glencoe
Business Management Specialist
Management Assistance Division
Small Business Administration
Charleston Branch Office

Client Consultation following adjournment of the workshop will be conducted by:

Mr. J. Knox McConnell

Mr. Michael Graham

Mr. Dean R. Kenny, Director
Center for Economic Action
Concord College

Packages of SBA Loan Forms will be available to participants upon request, as well as SBA Publications.

STARTING AND MANAGING YOUR OWN BUSINESS

Registration Form

Name _____

Address _____

_____

Phone _____

There is no registration fee for the workshop

Luncheon will be provided courtesy of First National Bank of Keystone

Please return this form to: Center for Economic Action, Concord College, Athens, WV 24712.
You may also register by calling the CEA - 384-9811 or 384-9211.

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Money

Functions of Money

There are three functions of money, (1) a medium of exchange (2) a unit of value, and (3) a store of value. In what is probably its most basic role, money is the "great wheel of circulation." Hence, it has been described an "exchange medium." Money as we know it today simply came about because of the demands of a complex economy.

When increased production became complex, an arrangement had to be placed in motion. To solve these various problems (exchanging 6 goats for a wooden boat) people soon started looking for one commodity that they can agree to exchange for all other commodities at fixed rates.

Through research I have discovered the following items used at one time or another for money: Stone, porpoise teeth , woodpecker scalps, boar tusks, and yes, even slaves. These items in themselves are awkward to carry. For these and other reasons, one valuable commodity, gold, tended increasingly to drive the others from the circulation system.

More recently still, monetary reforms have largely removed currency from its traditional form of metallic coin. But no matter what form it takes, its distinguishing features are convenience and universal acceptability. It is the stimulant of a modern economy.

Money has also been called "a Unit of Account." Behind this descriptive phrase lies the idea of a yardstick against which the relative values or prices of a vast multitude of commodities may be measured. Money supplies this yardstick. Instead of having to remember that a cartwheel is worth 10 bales of hay, the purchaser need only know that it costs $7.50. This simplification of the commercial process gives an important lift to economic activity.

Of the roles of money, "storage of value" has been traditionally considered the most important, but today it is undoubtedly the least important. True money has no ordinary use value; one cannot eat it or pave a street with it.

The reason for the publics declining preference for money as a store of value are threefold, (1) money held in the form of cash or in checking accounts earns no interest or dividends, (2) it can undergo no real appreciation in capital value, and (3) in inflationary times it steadily loses purchasing power. A combination of these factors has driven most stored value into investment channels. In bad times, capital tends to move back into forms believed to be inherently valuable. Liquidity is sought, such as gold.

Kinds of Money

In developed countries money usually exists in the form of paper currency, checking deposits, and coins. There are other forms, and the specialist will tell us that many subtypes exist within these three general categories. These qualifications are important, but we can hardly enter into much detail here.

Currency printed on paper is fairly recent innovation, but paper money has gained general acceptance in stable countries. It may be divided into two types: representative and nonrepresentative tender. The former is "backed" by silver or gold held in the treasury of the state issuing the notes. In some instances the issuing treasury will exchange the notes for a given quantity of the supporting metallic reserve, but representative money is usually nonconvertible.

Nonrepresentative notes, also called rather contemptously "fiat money," have no backing in bullion. Their sole backing is the credit of the issuing state. Orthodox economists generally oppose granting government the right to issue nonrepresentative bills. They fear that in times of difficulty the government will try to solve its problems (that is, pay its bills) by resorting to the printing press. Uninhibited creation of currency will certainly lead to inflation, but the flexibility of the unbacked issue, which does not bind a treasury to an arbitrary and otherwise useless stock of bullion, perhaps makes up for the potential dangers — that is, assuming a responsible political administration. During the Civil War the United States was forced to print several hundred million dollars in fiat money, popularly called "greenbacks." Up until 1968 a compromise solution had been reached as the law required a certain ratio (a minimum of 25 percent) between the currency issue and the support reserve in gold.

International pressures, however, forced the United States to drop this requirement — thus placing the burden for maintaining a stable currency on the government's capacity to maintain confidence in the economy. By far the most important form of money in the modern economy is the bank check. In fact, the money supply nowadays consists largely of bank deposits, which may be transferred to pay debts. Most large financial transactions and many small ones are completed with the aid of checks. From an economic viewpoint a bank check for $50 is money; it does not merely represent an equal number of actual dollar bills that are kept elsewhere. Many people seem to have trouble grasping this point, perhaps because of the traditional identification of money with the circulating medium. Convenience, more than any other factor, has served to make checking accounts the most important element in the money flow of the modern economy, so that nine tenths of all transactions, by value if not by number, are handled through checks.

In summary, then, it may be noted that although the government theoretically has the sole authority to create money, most of it is, in fact, created by commercial banks, through checks, subject to general regulation by the government. Money supply depends for the most part on the supply and demand relationship between bankers and borrowers. The Treasury and the Federal Reserve have considerable power over how much money the banks will be allowed to lend. But the money stock, or what the Federal Reserve calls the money supply, consists of these major elements: coins, paper currency, and demand deposits. It is the last which accounts for most of the money in the American economy. When the Federal Reserve System was established in 1914 it meant some thing to say that a Federal Reserve note was redeemable in gold coin or gold certificate. When the word "redeemable" appears today it is practically meaningless and the statement "this note is legal tender for all debts, public and private" is more accurate and indicates the crucial nature of "acceptability" in a money system.

Credit

Credit, no simple concept, plays many public and private roles and has many subtle influences. We shall not attempt here a morphologically complete description of the credit machinery but shall instead try to point out the significant functions that credit performs in the economy.

For many centuries debt had a bad name in Christian societies. To be in debt was morally undesirable, but to place others in debt was deemed especially reprehensible. Perhaps some of the traditional Christian horror of debt was inherited as a reaction against the old Roman practice. In pagan Rome, usury was common and accepted. Many of the most famous facilities of antiquity made and held fortunes through money lending, often at exorbitant rates of interest. The great latifundia of the later Empire were to a large extent built on the basis of expropriation of land for nonpayment of debt. The more unscrupulous leaders came to lend money more with the idea of foreclosure than with intent to earn a fair return on capital. Roman law was largely class law and heavily favored the interests of the creditors.

The Church's traditional opinion of usury was particularly low, though modern scholars have perhaps exaggerated the clerical objection to credit when granted on reasonable terms. One must separate the theological objection to money increasing itself from the practical working-out of the anti-usury injunction, which was primarily employed to prevent the exploitation of the weak and destitute. A survival of this social regulation of credit may be found in the many existing statutes — all too often circumvented — that place ceilings on the legal rate of interest. In the Middle Ages, the Church and not the state was the bane of the loan shark. As Pope Innocent IV opined, correctly for an age of low capital formation, "he who borrows is always under stress of necessity."

Functions of Credit

Much of what we have said about the necessity of money to economic activity applies also to debt. The credit system is probably just as crucial to our industrial way of life as money itself, although the relationship is undoubtedly less obvious. And again, as with money, the utility of credit is both personal and public. A few examples will readily demonstrate the truth of these statements.

An engineer working for a large firm has an idea for a new product, which he thinks he would like to develop himself. However, the cost of going into business for himself is too high. Unless outside credit is available, supplied by others who share his enthusiasm for the new idea, the innovator might have to wait many years to bring his product to the market. Perhaps he could never save enough from his salary to begin the undertaking. In that case, both he and society would be the losers. Along with the benefits that the public might gain from the product itself, there is a negative side to consider. Jobs, dividends, taxes, and careers could be lost; hence, to start new industry, debt is often very

necessary. Even large, well-established firms often have to enter the debt-capital market to finance their expansion plans.

But it is not only the establishment of new businesses or the expansion of old ones that requires borrowing: thousands of enterprises need credit as a regular part of their year-to-year operations. Consider the predicament of a distributor of a seasonal commodity — say girls' swim suits. A fairly large sum of money must be tied up each spring in inventory, and often the capital needed is beyond the resources of the retailer. He must therefore borrow to "finance his line." Even large corporations find it convenient to incur short-term debt to meet certain recurring temporary demands for cash.

But while there is little debate over the need for business debt, there is argument aplenty over personal or consumer debt. The growth of individual debt in the United States during the last few years has been truly astonishing, especially when one considers that it has accompanied times of prosperity rather than of recession. Modern consumer credit has far outpaced the old-fashioned charge account, which only the well-to-do could once afford to maintain at their favorite department stores. Perhaps the majority of consumer durable goods sales today are made partly on credit, with repayment terms often extending over several years. Many thoughtful observers feel strongly that the United States is on a "buy now, pay later" binge. What are we to expect if poor business conditions cause a sharp drop in personal incomes? Will a large and damaging number of credit defaults follow?

Further, the opponents of easy consumer debt believe that it has over stimulated the economy in the postwar period. The post-World War II prosperity, they assert, has been distorted by the vast increase in sales that could not have been made without credit. The eventual result of this consumer goods boom, as they see it, can only be a catastrophic bust.

Champions of high consumer credit arrive at nearly the opposite conclusions. They assure us that the prosperity of the last few decades has been founded in considerable part on time sales; without this credit innovation we would already have seen bad times of recession or depression. According to them, easy consumer credit is a permanent change in the American economy. Though it violates certain traditional views concerning thrift, its overall social effect is beneficial. To the objection that excessive consumer debt encourages cyclical instability, they reply that the best way to avoid recession is to increase the purchasing power of the consumer. Credit, they maintain, is an excellent if unorthodox means to achieve this end.

It is impossible to determine at this moment which of the two viewpoints is correct or even which has the more truth in it. Perhaps both will be found to have some validity. Certainly consumer credit has become an integral part of our economy and much of the postwar prosperity is related to it. However, the conservative insight can not be summarily rejected because very high levels of personal debt to have inflationary effects that exaggerate the swing of the business cycle.

The Banking System

The key to the national credit picture is the individual bank. Originally banks developed from the practice of individuals leaving their gold with goldsmiths for safekeeping. These men, in turn, lent it to others in return for interest and gradually began to replace the actual metal with promises to pay on demand. After a period of time, these "promises-to-pay" began to exceed the actual amount of gold on hand. Thus developed the need for what are called fractional reserves. The only danger was that the banker had to determine what percentage of his total loans he must be able to back up with metal, and he had to be careful to insure that he did not have too many debts. Today it is far easier for a bank to operate with fractional reserves because of the laws which govern what percentage should be kept in reserve, the laws which state what kind of loans may be negotiated, and because of the experience gained by bankers throughout the years.

There are about 13,500 commercial banks, 517 mutual savings banks, and over 6,200 savings and loan associations in the United States today. These range in size from multibillion-dollar institutions down to the small country bank with assets of a million dollars or less. In this discussion, the focus will be on the role of the commercial banks.

Individual banks create money largely by making loans and buying securities. How this creative process occurs can be simply illustrated by reference to the handling of checking accounts. When money is deposited in an individual's checking account it becomes an asset for the individual, but both an asset and a liability for the bank. It is an asset in the sense that it becomes part of its cash on hand, but a liability in the sense that the bank must pay it to the depositor on demand. However, the deposit does not earn interest. Moreover, the bank is not required by law to keep the entire amount on hand for possible payment to the depositor — only about 20 percent. The balance can be used for other transactions. In addition, since the bank is obligated, again by law, to keep its required reserves in the Federal Reserve Bank, the individual's original amount is worth five times this in deposited reserves. The balance of the amount of the individual's deposit is lent to others. Naturally, this draws interest to the lending bank, which is making the assumption that the individual will leave his deposit in the bank for some period of time. Often, the loan gravitates to another bank in the form of a deposit and the process is repeated. As the available or "loanable" portion of the original deposit moves from bank to bank, it keeps creating more money in the form of loans.

The fact that there are many banks in the banking system makes the operation in a sense self-contained. An increase in the deposits of one bank usually means an increase in the deposits of another. Since the flow is generally two ways, and the number of individuals large, the banks can usually count on smooth expansion operations. As a safety precaution as well as for operating ease, most banks keep some part of their deposits in cash, which averages about 2 percent and is called "till money." It follows that as banks expand their deposits they also increase their assets, not only in notes for loans but also in other securities and governmental obligations. To perform these operations,

they must, of course, first have reserves. Conversely, the banking system contracts the money supply by decreasing the size of its loan and securities portfolios. Hence, the operations of the individual banks affect and partly control the general level of business activity. When there is an increase in lending activity, business tends to expand. When lending activity slackens, so does commercial activity.

The reaons for these tendencies are not far to seek. Loans are used to hire workers, buy materials, build or rent additional business space, and so forth. All such individual acts mean business for others. More cash in the worker's pocket means more sales for the retailer and hence more orders for the wholesaler. More trade for the wholesaler means more orders for the manufacturer. More rent for the landlord and more business for the producers of raw materials follow. And the wages and profits of these industries return to the retailer in payment for still more sales. But, when bank lending falters, the opposite chain of events is set in motion. All along the line there is less: less trade, fewer orders to fill, fewer men to hire, less income to spend, and fewer goods to produce.

However, we must stress that the aggregate of commercial-bank activities does not by itself determine the level of business activity. Many other factors are involved. The operations of the banks are as much determined by the economy as they determine it. There is a two-way relationship of cause and effect that works out in very complex ways in the economic world. A bank loan to a retailer to expand his business leads directly to more jobs and income and indirectly, through the ramifications of this new income, to a minute upturn in the entire economy. But if the retailer's trade is already poor, he may never dream of coming to the bank to finance an expansion. What would be the point of going into debt for a bigger ship with fewer customers? In this case, the general condition of demand sets a limit to the possible influence of the banks in creating more money and prosperity. Perhaps the best way to grasp this situation is to think of the volume of new credit as an accelerating factor in the business cycle, one that can reinforce business trends in either direction but that cannot to any substantial degree itself initiate an upturn or a downswing.

The United States was one of the last major nations to establish a central bank. When legislation was finally enacted in 1913, it was long overdue. As Carter Glass of Virginia told the House in that year:

"The failure of the system in acute exigencies has caused widespread business demoralization and almost universal distress. Five times within the last thirty years financial catastrophe has overtaken the country under this system; and it would be difficult to compute the enormous losses sustained by all classes of society . . . The system has literally no reserve force. The currency based upon the nation's business needs. The lack of cooperation and coordination of facilities at all periods of exceptional demand for credit."

Because of the tremendous demand for loans, local bankers often took unwise risks which resulted in failure of the bank. This problem was not confined to one community but often spread to others, either through commercial obligations of the failed bank or to the famous "run" on the bank for capital that it did not have. The "local" nature of these banks worked both to their benefit and their loss. The banker knew the local conditions and the local individuals, but was often an

amateur or a promoter. Moreover, strictly local conditions often created a tight financial position that was not typical of the country at large. Obviously a growing nation needed facilities for more widespread pooling of funds. In the midst of the Civil War, Congress created the National Banking system to discipline the banking community through tightened reserve requirements and original capital funds. Nevertheless, the tradition of local banking remained strong.

The money panics of 1873, 1884, and 1907 were caused by currency contractions and by seasonal withdrawals of reserves by Western banks from their New York correspondents. The contraction was due to the fact that "Northern" currency had to supply the whole country when the Civil War ended. Because tax collections were greater than expenses, the government began to redeem "greenbacks" and the Treasury was later able to retire much of the debt that provided backing for the national bank notes, with the result that the supply of these notes contracted. An expanding economy facing a contracting currency was destined for trouble.

Within this context, any substantial withdrawal of funds could easily precipitate a crisis and this occured when Western farmers, at harvesting time, often needed to withdraw savings from the local banks or negotiate loans to move their crops to market. The Western bankers, on the other hand, normally held part of their reserves as deposits in the larger New York commercial banks. When these were suddenly called for en masse, the New York banks were often embarrassed; they in turn recalled loans, which usually could not be renegotiated by the debtor elsewhere, since all the big city institutions were temporarily short of loan funds. A brief but damaging credit panic would typically occur. A depression in miniature was induced: jobs, income and capital were lost.

To end these panics, the Federal Reserve System was, in effect, empowered to create money for the commercial banks in times of credit stringency. It also undertook many other fiscal housekeeping chores, such as national check clearance and member-bank examination. The "Fed" is not, however, a true central bank. Rather it is a decentralized central bank, if such a concept is possible. At the time the Federal Reserve Act was enacted, it was feared that a true central bank on the European model would become an organ of centralized political power; a compromise was therefore reached. The Act established 12 regional banks, each having a considerable degree of autonomy but with a higher Federal Reserve Board sitting in Washington to oversee the whole system.

Two major functions of the Federal Reserve Board are, first, to hold the legally required fractional reserve deposits of member banks, and second, to fix the amount of required reserves. Actually, only an insignificant fraction of a member bank's reserve deposits are in the form of real currency. Reserves normally consist of gold certificates plus loans to other banks or assets like government bonds purchased by payments made in the form of additions to the accounts of member banks. Gold certificates originate when the Treasury Department purchases gold for member banks which accumulate the gold through foreign exchange. The gold certificate is issued by the Treasury to replace the deposits that it has shifted from its own account to the

account of the member bank from which the gold was purchased.

There are other ways to increase its deposits. Through "rediscounting," for example, the Fed can lend money to a member bank which needs to increase its reserve deposits. As collateral, the member bank turns over to the Federal Reserve Board some of the notes it holds from its borrowers. In return for this service, the Fed takes a percentage of the face amount as its own profit by discounting the note — that is, by not paying the full face value. Sometimes, the Fed goes into the open market in order to increase its reserves and thus create deposits on its own initiative by buying government securities.

These various operations enable the Fed to play a role in the economy far more substantial than that performed simply by serving as a reserve depository. This new role is closely related to the business cycle. Since the 1930's the Fed has become a leading instrument of government countercyclical policy. The reserve banks, through appropriate policies, indirectly create or destroy money and expand or contract the money supply. During periods of inflationary boom the System ups the percentage reserve requirements that the member banks must maintain with the central bank. Thus, the commercial banks have less money to lend out and the boom tends to slow down. During periods of business slack the Fed lowers its reserve requirements on deposits, and additional funds flow out into the economy. A similar effect is achieved by the System's open-market operations in government securities. When the Board wishes to contract the lending base of the commercial banks, it offers securities at prices that may prove relatively attractive as bank investments. When it wishes to pump money into the economy, it offers to purchase securities at relatively favorable prices and thus releases funds for business loans.

There is little doubt that, within a limited range of commercial fluctuation, the monetary policies of the Federal Reserve System are highly effective. But they seem inherently better suited to control the rising phase of the cycle than the downward reaction, especially if the reaction is sharp and prolonged.

A further check to the effectiveness of the Federal Reserve's countercyclical policies arises from the fact that much credit originates with lending institutions outside the commercial banking system. In addition to savings banks and savings and loan associations, insurance companies, credit companies (such as CIT and GMAC), and many factoring firms are constantly supplying individuals and businesses with loans. Except through very indirect means, the Fed is unable to counteract the legitimate activities of these and other sources of credit.

Term Loan

The term loan has taken on several key and distinguishing characteristics. Term loans are for a period of at least one year and can be for as much as fifteen years' maturity. Second, periodic or serial repayment typically is required. Although many term loans call for equal repayment during each year of the life of the loan, the schedule of repayments customarily is designed to fit the circumstances of the

borrower as well as the needs of the lender. Third, in the term loan the relationship between the borrower and lender togehter, the terms of the loan usually are worked out directly over the conference table by representatives of the lender and the borrower. Although two or more lenders may combine in providing the money under a single term loan agreement, the number of lenders is usually small. Fourth, the direct relationship between borrower and lenders permits a "tailor-made" loan agreement. The typical term loan agreement has many provisions. So long as a borrower continues to carry out the commitments agreed to in the term loan agreement, the lender can require payment only in accordance with the maturity schedule specified in the loan agreement. The typical term loan agreement, provides, however, that failure to comply with any important provision of the agreement accelerates the maturity of the loan so that the lender legally may demand payment of the full amount.

A basic fact that the term lender must face in considering a loan for a period of years is the near certainty of major change in the situation and affairs of the borrower before the loan is repaid. Five, ten, or fifteen years is long enough in our dynamic and competetive economic environment for material developments to occur in the management of any borrowing enterprise, in its products, its markets, its competetive position, its industry, and in the general level of prosperity under which it operates.

Of course, lenders have always had to cope with change. The key point here is that the extent, speed, and intensity of change in our present-day economy particularly complicates the job of working out lending arrangements that will stand up for years under rapidly shifting circumstances.

During almost three decades of active term lending, lenders have developed a variety of measures to restrict the risks inherent in term credit. As in the case of all "bargaining for funds," the final provisions of a credit reflect the bargaining strength of the parties as well as the objectives of each party. When credit is easy and the supply of funds for loan investment exceeds the demand, competitive pressures commonly force concessions on the part of the lenders, would be successfully resisted. But regardless of what competing lenders might do, the intelligent lender must at all times keep his risk taking in line with his prospective rewards for risk taking.

Since most term loans are for sizable amounts, as well as for considerable periods of time, the credit analysis of a typical term loan application is more comprehensive and thorough than for short term credits. The industry in which the company operates and its vulnerability to downturn in business conditions is the subject of close scrutiny. Industries with a history of vulnerability to cyclical changes in demand are obviously less attractive than those which have stood up well under depression conditions.

Particular emphasis in the analysis is placed on the long-term profit prospects of the borrower's industry and of the company within the industry. Loan repayment over a period of years is highly dependent on

profitable operations. The protection afforded by even a very strong asset position can be swept away by only a few years of heavy losses. Looked upon with favor are companies with a diversified line of products which have built-in protections against especially rigorous competition. Such protections include particularly strong quality features in their products. Research effective in developing profitable new products, strong consumer brand loyalty, or fixed asset requirements great enough to discourage entry in the field by new competitors. Established, stable product lines are preferred over high-style or novelty items.

Term lenders place much stress on appraisal of the competetive effectiveness of the applicant's management. Certainly an alert, able, and aggressive management is essential if even those companies most successful in the past are to make the adaptations necessary to keep ahead of competition in a dynamic economy. But, as an intangible, the character and skill of management is not easy to measure and project into the future. For example, the past success of a particular company may be due largely to a top management team that is nearing retirement so that another generation of management, as yet not fully tested, may hold the key to the future. However, if the lending institution has had a long relationship with the would-be term borrower, its officers have considerable opportunity to get a useful, if inconclusive, size-up of the caliber of those who will guide the borrower's affairs in the future. Put most simply, the question to be answered is: "Is this the kind of men able to be light on their feet if major problems knock them off balance?" Or, "Will these people do all right, come what may"?

The emphasis on profit prospects and relative de-emphasis of balance sheet analysis does not mean that such items as the working capital position or the relationship of debt to ownership funds are ignored. It is more an implicit recognition that even though working capital is adequate for the apparent near-term needs of the company, and the debt/equity position is reasonable, the long-term maintenance of a healthy balance sheet must hinge on profitability, which not only provides funds for debt service but forms the basis for equity or other financing as needed.

One of the main protections against risk built into term loans is the typical provision for installment repayment beginning soon after the credit is extended. From the outset of the loan the borrower is forced to think of repayment and to plan for it as an integral part of his financing. Most lenders prefer to set repayment schedules that have no large "balloon payment" until the final maturity date. Indeed, many see a need by the borrower for deferral of large amounts of the final maturity as a confession of weakness in the loan application. While conditions at final maturity may be sufficiently favorable to permit refunding or extension of the unpaid amount, there is no assurance that this will be the case.

Provision for installment repayment from cash provided by retained earnings compensates to some degree for the risks inherent in term loan commitments inasmuch as the size of the loan is reduced as time goes

on. At the same time as repayment is made from cash from retained profits, the ownership equity (in the form of earned surplus) increases so that the debt/ownership relationship is improved both by reduction of the debt and by the retention, in a balance sheet sense, of the earnings in the business. Some have labeled term loans repaid out of profits as programs of "forced reinvestment of earnings".

In setting repayment schedules, effort is made to forecast cash flows from earnings and other sources and, after allowing for anticipated cash needs of the business, to shape the timing and amount of the repayments to the anticipated "cash throwoff", or cash generating capacity of the business. Particular reliance is placed on profits as a source of funds for loan repayment. Depreciation as a source of cash is not ignored in the analysis of anticipated cash flows. However, most lenders prefer to consider the cash generated from depreciation and not committed to the purchase of new fixed assets only in appraising the margin of safety left the borrower should profits fall off. Regarded in the same light is the extra cash that might well be made available as a consequence of a decline in sales receivables. Furthermore, few lenders like to count on the full anticipated profits to cover loan repayments, preferring to have a comfortable cushion against unforeseen difficulties in a substantial excess of anticipated profits over loan repayment requirements.

Of course, the ironical observation that "them what has gits," applies to loan repayment scheduling. In the case of companies with excellent prospects for large, continuing profits, who could afford quickly and more prepared to accept the risks of a long loan with smaller repayments. Conversely, lenders are more anxious to keep short term means higher installment payments. Speaking generally, effort is made to compensate for higher risk shorter repayment schedules.

A frequent feature is a provision requiring repayment of a percentage of profits in addition to the fixed minimum installment. This contingent requirement is common where the credit analysis suggests the likelihood of very large but fluctuating profits. From the lender's viewpoint it provides an opportunity for getting paid "while the getting's good" without embarrassing the borrower if profits prove only moderate.

Since profit forecasts are at best estimates, "tailoring repayment to cash throwoff" remains an art rather than a science. The repayment schedule frequently is a major bargaining issue during the term loan negotiation, the borrower seeking as lenient terms as the lender is willing to supply.

Typically, provision for repayment at the option of the borrower is also made in the term loan agreement. Commonly, prepayments are applied to reduce the principal in inverse order-that is, applied against the most distant installment rather than the one next due, so that they are not a substitute for regular repayments. Usually lenders insist on provisions calling for prepayment fees, but this matter is often a matter for bargaining.

The direct relationship between borrower and lender implicit in the term loan affords greater opportunities for the lender to restrict the risks

he sees in a long-term commitment to a prospective borrower by means of restrictive agreements specifically drawn to suit the needs of the two parties. Furthermore, most term loans are made in the expectation that should events make some of the provisions unnecessary burdensome or obsolete, the lender as a continuing lender anxious for more business would agree to reasonable modifications. Where only two, or a few, parties to the term loan must be satisfied, the mechanics of change of the loan provisions are very much more easily accomplished than in the case of bond issues, where several hundred or thousand holders must be persuaded to acquiesce to changes desired by the issuing firm.

Most terms lenders have become skilled and resourceful in working out provisions in term loan agreements that are acceptable to the borrower yet provide important protection against risk of serious deterioration of the credit. Since lender and borrower are free "to agree to anything they can agree to," much variety is found in the restrictive provisions from one term loan to another. However, a number of provisions fall into several useful categories:

1. Restrictions on major changes in the borrower's business.
2. Restrictions on additional borrowing.
3. Provisions relating to maintenance of working capital.
4. Restrictions on diversion of assets
5. Provisions relating to security.
6. Other provisions.

A first of provisions represents assurance against certain types of changes that could be so important as to alter substantially the nature of the borrower's business and hence of the term loan. These include prohibitions during the life of the loan of the following:

a) Sale of the assets of the company other than in the normal course of business — for example sale of an obsolete machine would be permitted, sale of a plant would not. Sale and lease-back deals often are prohibited.
b) Merger of the company with other companies.
c) Major changes in the management of the company.

Of course, the prohibition of such actions is not absolute but rather should be interepreted as meaning that they can be taken only with the consent of the lender. For example, if the borrower were able to present a strong case of selling a major plant, the lender might well waive his rights under the provision, perhaps insisting that a portion of the proceeds be applied toward prepayment of the term loan. In effect, if the other terms of the credit are to continue, the lender has a veto power over such actions, but one that a reasonable lender anxious for more lending business in the future presumably would use with discretion.

What happens if the borrower breaks the agreement without permission of the lender? The basic and typical penalty for uncorrected breach of any major provision of the term loan contract is the automatic acceleration of the maturity of the loan — that is, the lender may insist upon payment of the full amount outstanding and take legal action to

assert his rights. If the borrower cannot find the funds to repay, the lender is very much in the "driver's seat" legally and may well demand drastic action by the borrower; even if he doesn't choose to precipitate legal proceedings. So the provisions can have real force.

Provisions restricting or prohibiting additional borrowing are very common and may take one or more of several forms. If security is not taken, a "negative pledge clause" is frequently used – that is, that no assets may be given as security to any other lender. Presumably, the borrower would be able to get large additional loans on an unsecured basis only if the firm were in a strong financial condition. In any case, the negative pledge agreement protects against the possibility that another lender could get a prior claim to assets otherwise behind the term loan and other unsecured credits.

In addition, other long-term debts may be prohibited entirely or alternatively, permitted only if the company's statements can meet certain ratio requirements that are set up so as to prevent more long-term debt except in circumstances where the financial position of the company is so strong that the additional risk added by the further debt is clearly tolerable.

Many companies seeking term loans borrow also from banks or other short-term lenders for seasonal or other temporary working capital needs, and the continuation of such borrowing may be entirely sound from the viewpoint of both the borrower and the term lender. Hence, provisions regarding short-term borrowing frequently seek only to prevent excessively heavy short-term borrowing — by fixing a maximum limit on such borrowing — and to bar long-term borrowing in the guise of short-term notes continuously renewed-by a requirement that the company be out of debt to the banks (for other than the term loan) for a significant period each year.

Another group of provisions seeks to guard against continuing deterioration of the current position of the borrower. The long-term profits looked to for loan repayment may be jeopardized if the borrowing firm does not maintain sufficient working capital and current credit standing to permit normal conduct of its business. Furthermore, in the event serious trouble should develop and the lender were forced to look for repayment from liquidation of the borrower's assets, the lender would like to have the prospect of substantial pay-out from current assets — typically the most liquid and often the most yielding assets in case of liquidation — and heavy current borrowing would dilute the term lender's prospects of repayment from liquidation of current assets.

One of the most important of the requirements aimed at preservation of strong working capital position is a limitation on acquisition of fix ed assets. Undue diversion of cash into plant, equipment or long-term investments may hamper normal operations and jeopardize repayment of the loan. Consequently, term lenders frequently demand restriction of fixed asset acquisition to an amount no greater than the funds supplied from depreciation charges or to a fixed-dollar maximum. Such limitations are often the subject of vigorous bargaining and, over the full life of the term loan, are among the provisions most frequently modified by mutual agreement.

Many lenders rely on a requirement that the current ratio of the borrower be maintained above a minimum figure, such as two to one, counting on this requirement for protection against excessive current borrowing, or undue diversion of liquid resources into fixed assets. A minimum "net quick" ratio requirement is also included frequently.

Another provision used in lieu of, or, more commonly, in combination with, the minimum current ratio or net quick ratio requirement insists on maintenance of net working capital above a stated minimum dollar amount or above a minimum figure which is a multiple of the amount of term loan outstanding.

In the bargaining process and the drafting of the term loan agreement, it is important that both borrower's and lender's financial specialists be backed up with competent and experienced legal counsel. Lenders find dealing with borrower's counsel who are unfamiliar with customary term lending practice a frustrating and strenuous affair, as such counsel are inclined to see a trap in every paragraph. On the other hand, the potential importance of the loan provisions dictates that they be taken seriously and drafted with foresight care to detail.

From the borrower's viewpoint, it is important that top management of the borrowing concern understand the loan convenants thoroughly since the provisions may well contain implications important to many top management policies such as rate of expansion and dividend policy. Although in a few cases, the negotiation process may be delegated to the financial officer, top management always should accept the responsibility for the final terms and their built-in implications for the company's future.

The big advantage of term loan credit to most borrowers is the contractual assurance of credit for a set period of years. Armed with a credit made available under terms explicitly set forth in writing, the borrower can make commitments of his funds and enter into plans and projects consistent with the terms of the credit. Usually, these involve long-term investment of the borrowed funds in equipment, plant, or other assets that will "pay out" only over a period of years. Yet it follows clearly from the foregoing discussion of restrictive covenants typical of term loans that the assurance of credit is a conditional one, dependent upon the borrower's meeting fully the terms of the loan agreement throughout the life of the credit. The "accelerated maturity" feature of the loan agreement can be severe penalty for acts of default by the borrower. Even if the lender does not avail himself of his rights to insist upon accelerated payment of the loan, the lender may well be able to insist upon new terms and restrictions that are very onerous from the borrower's point of view. In effect, the defaulting borrower must "bargain on the flat of his back" — an unenviable position, to put it mildly.

Consequently, the astute term borrower must appraise the proposed terms with care and foresight. If he plans carefully and bargains skillfully, the restrictions arrived at may be entirely reasonable and represent a quite tolerable risk to assume. But even though they are judged acceptable, it must be recognized that the restrictions inherently do restrict the flexibility of management at least to some degree.

Essentially, the major disadvantages of term borrowing, however, are those of any borrowing. Lenders expect debts to be repaid; the penalty for nonrepayment can be severe. Further, loan funds are not like water from an ever-flowing spring — the more a borrower draws on his ability to borrow, the lower is the level of additional borrowing power for the future expected or unexpected needs. Debt money is "unfriendly money"; it repels other money, unless it is used so profitably as to attract additional equity investment.

The typical term loan involves only one or a few lenders. The term loan borrower is dealing with an informed, sophisticated lender, who can be expected to be vigorous in protecting his sizable investment. Compared with the creditors in the form of small investors who buy a widely distributed issue of bonds, the term lender is a fast-moving, informed creditor who has such a big stake in the credit that he can be expected to follow it carefully and to defend his rights effectively.

While the term lender can usually be presumed to be an intelligent and reasonable creditor who will react sensibly to requests for modification or adjustment in the loan, it is important that the borrower recognize an inherent or potential conflict of interest between himself and the lender. Many possible modifications that seem clearly desirable from the borrower's point of view will not be attractive to the lender. Consider, for example, the situation of a borrower who sees opportunities for expansion into a new field that promises big profits but contains substantial risks. The borrower might well, in view of the profit outlook, be willing to assume the risks to him of more debt and hence want the term lender to waive restrictions on further debt. But the term lender, who gains little from extra profits from expansion, may well, intelligently and reasonably, refuse to increase his risks by permitting the expansion of debt.

For most term borrowers it is highly important that the term loan arrangements be negotiated effectively. What aids to successful term borrowing can be suggested? Our more important suggestions can be grouped under the following headings:

1. Top management's role in negotiating term credit.
2. The need for understanding term loan theory and practice.
3. The search for a suitable lender.
4. Appraisal of provisions and selective bargaining.
5. Maintaining the term loan relationship.

In brief, term borrowing is intertwined with many matters of significance to top management. Top management understanding and participation in the planning and decision making that is a part of effective term loan negotiation is essential to term borrowing that serves rather than stifles attainment of management's objectives.

Even with the best possible advance planning at the time the term loan is negotiated, it may become highly desirable for the borrower to secure the lender's agreement to modification of the loan terms at some time during the life of the loan — or to further credit at some later date. In his own interest, the borrower should act to keep the lender's good regard throughout the loan.

It is hard to overemphasize the importance of providing the lender with good and candid information but throughout the loan as well.

Since the lender has an important financial stake in the enterprise, his interest in timely notice of major developments affecting it — favorably and unfavorably — should be taken for granted and freely met.

If modifications of the agreement are needed, the borrower should give the lender as much notice as possible of the impending need for change and carefully work out appropriate modifications to propose. Similarly, as the borrower has unfavorable developments to report, he should have plans worked out to cope with these developments. While the lender wants to know of impending problems, he does not want them thrust in his lap for solution. Instead he is entitled to evidence that the borrower is making constructive plans to overcome his own problems.

Yet in the final analysis, there is no adequate substitute for effective performance — the meeting of commitments — as the foundation for a sound and viable borrower-lender relationship.

Mr. LAFALCE. I wish you well in that endeavor.

Gentlemen, I want to thank you both for the excellent presentations you have given us about how important the SBA guaranteed loan program is, both to the small business community that you serve and to your own financial institutions. I intend to be carrying that message to all my colleagues, not only on the Small Business Committee, but to the entire Congress in an attempt to defeat the administration's effort to emasculate the SBA guaranteed loan program.

As I said, the reduction in the guaranteed loan program this year was $4.5 billion; if the President gets his way, it will be $2.4 billion in fiscal year 1983, and he will bring it down to about $1.1 billion in fiscal year 1987. This is the exact opposite of what we should be doing, particularly in light of the most revealing statistics revealed to us by the President's Report on the State of Small Business, published in March 1982. It would seem to me that the financial institutions in America—in addition to the small businessmen—should be up in arms about this because this is such an important program to the small banking institutions, the types of institutions represented by IBAA [Independent Bankers Association of America].

In any event, I am afraid we are going to have to recess today's hearing because there is a meeting of the Democratic Caucus at 11 a.m. for nominations for committee vacancies in the Hall of the House of Representatives. Hence, the subcommittee will now adjourn.

[Whereupon, at 10:59 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

[The following was submitted by the SBA for insertion in the hearing record:]

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CAPTIAL GAINS REDUCTION
SMALL BUSINESS AND JOB CREATION

Small business has from the time of this Nation's inception been the vanguard of the free enterprise system; it provides jobs, helps deter high prices, and is responsible for much of the innovation and development in the marketplace.

As this paper will demonstrate, investment in small business does more than help them remain financially strong; it helps the Nation's economy directly. The tax cuts proposed herein for small business investment do not result in revenue losses but actually will put dollars into the Treasury. For every dollar lost the gain is substantial. The total estimated revenue "loss" from reducing the rate of capital gains tax by 50% on equity investments in small businesses engaged in a trade or business is estimated to be $159 to $176 million. Revenue gains from the jobs created by capital raised from such a reduction would be significantly higher.

These views represent those of the author and not necessarily the views of the Chief Counsel, the Administrator, or the Administration.

A. Role of Small Business

In this time of high inflation, tight money and threatened high unemployment, we have to look at the role of capital and small business in a new light.

It is well established that small business, especially in certain innovative areas, has done more to create jobs than large business. Small concerns with 20 or fewer employees created 66% of all new jobs in the private sector between 1969 and 1976 and 87% of new jobs came from firms with 500 or fewer employees. 1/ The Fortune Magazine list of the 1,000 largest manufacturing corporations created only 75,000 jobs during the same period. 2/

There are startling statistics that should be a critical factor when any discussion, planning or analysis of employment and/or business trends is discussed. Too many of our job creation programs have been aimed at Government or large businesses rather than small businesses.

As the Nation's innovators, small business should receive help rather than be hindered by Government programs. Small businesses received approximately 3.5% of all Federal research and development (R&D) dollars 3/ during the time when Government studies show that these businesses were responsible for more than half of all scientific and technological developments since the beginning of the century. 4/ A National Science Foundation study has shown that from 1953 to 1973 small businesses produced four times as many innovations per R&D dollars as medium-sized firms and 24 times as many as the

largest firms. 5/ These innovations created substantial employment and productivity benefits.

A study conducted by the Massachusetts Institute of Technology Development Foundation compared the performance of six mature companies, five innovative companies and five young, high technology companies. 6/ From 1969 to 1974, the average annual contribution of those companies in terms of jobs and revenues was as follows:

Type of Company */	Sales Growth	Job Growth
Mature	11.4%	0.6%
Innovative	13.2%	4.3%
Young High-Technology	42.5%	40.7%

The need for a strong small business sector is further highlighted by the role it plays in creating a competitive economic climate. No single factor will better insure a competitive marketplace than a large number of businesses striving to make a profit. This competition has always led the way to lower prices and better products and services.

Small business plays a tremendous role in our economy and the maintenance of a viable, strong small business climate must be of paramount concern. Despite small business' critical role in our economy its share of the U.S. economy has been declining at an alarming rate of .4 to .5 percent each year.

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*/ Mature Companies are large, well-established large businesses, Innovative Companies are those that started with an innovative idea and have been in existence over 5 years and Young Technology Companies are new, technical firms in existence less than 5 years.

B. Proposed Reduction in Capital Gains Taxes for Small Business

After reviewing various methods of obtaining capital for small business, we have chosen for discussion a proposal for reduced capital gain tax rates on capital invested in small business. Not only would this proposal direct capital where it is most sorely needed but it would in the hands of the investors (instead of the Government) the decision of which small businesses have the potential for growth.

Under present law capital gains income is subject to a 60% exclusion and the remaining 40% is subject to tax at the regular progressive tax rate. In limited circumstances capital gains income is subject to an additional §55 alternative minimum tax. Capital losses are required to be offset against capital gains and allowed as a limited offset against ordinary income.

Proposal

The current rules on taxation of capital gains derived from small business investments should be changed. Under the proposed plan capital gains derived from new equity investments in small businesses* engaged in trade or business would be subject to a 80% exclusion, rather than the current 60%. Loss treatment would continue unchanged.

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*/ For purposes of this paper small business is defined as firms with less than $25 million in assets.

These changes would not only increase the capital formation ability of small business by luring extra dollars to small businesses but also would cost the Treasury little and would target investments exclusively to small businesses. If investments were held for a minimum period of three years, any revenue loss would be deferred for three years.**

C. Cost of Job Creation

It can now be demonstrated that reductions of capital gains taxes on sales of small business interests can be made without any adverse effect on the Federal budget. This follows from a comparison of the cost of providing one job by investment of the tax cuts with the beneficial effect on the Federal budget of providing one job.

Surveys have been conducted by the Small Business Administration 7/, the Farmer's Home Administration (FmHA) 8/, and the Independent Bankers Association of America (IBAA) 9/ to determine the amount of capital necessary to invest in small business to create one new job. The results range from $19,000 to $21,000 per job, however, to allow for inflation, $25,000 is used in this paper. Studies conducted by FmHA and the Economic Development Administration 10/ (EDA) show that when jobs saved, in addition to jobs created, are computed the cost per job is approximately $10,000.

** Other methods of encouraging investment in small business would have a similar effect. Reduction in capital gains was chosen because of low revenue loss and ease in administering.

For example, the IBAA studied SBA loan guarantees outstanding on May 1, 1978 and found that original loan values of $34 million resulted in the creation of 1,874 jobs. These loans in the aggregate created one job for each $19,000. An evaluation of small business concerns assisted by Small Business Investment Companies showed that the $12.2 million dollars invested resulted in a gain of 1,866 employees for an average cost per job of $6,538. 11/

These figures are based on money put into a business by a loan but they would also apply to money that is invested in small business. Previous calculations have not taken into account income and employment tax and social welfare program cost data.

D. Revenue Gains From Jobs Created

Assuming that each job created, or saved, results in compensation of $6.00 */ per hour and lasts for three years, the Federal Government is the beneficiary of $7,300 which is about $3,200 in additional tax revenue, and $4,100 in unemployment benefits and/or welfare payments for each of the three years. 12/

Government data indicated that each new job created by a small business lasts about three years. 13/ Thus, the tax revenue pick-up and the budget deficit reduction computed, would be threefold for the expected life of the jobs. While some of the new employees will leave for other jobs, the newly created vacancies will open up for other unemployed individuals.

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*/ In 1976, the average hourly wage for a business with under 100 employees approximately $5.40. Six dollars is used here to account for inflation.

The Cost Benefit Analysis chart on the next page shows the gains most clearly. The revenue loss column shows that for each $25,000 invested in a new job the loss of tax revenues under the proposed 80% capital gains exclusion would be $1,400 at most. This is based on an effective rate of 28% which is the maximum. Most capital gains are taxed at a lower rate. In fact, Treasury Department statistics computed before the reduction of capital gains taxes show the average rate of tax on the net of capital gains and losses is 15.9%. 14/

The revenue gains are based on taxes paid, both income and FICA, and direct Government savings in unemployment and/or welfare benefit costs. Since the average job last three years, the benefits are $22,041 for the three year period, which is 16 times the revenue "loss" of $1,400.

It is important to note that these figures do not take into account increased tax (income and sales revenue) to state and local governments.

Treasury Secretary G. William Miller used this kind of analysis in his testimony on Federal loan guarantees for Chrysler Corporation. 15/ He indicated that preserving (not creating) the 75,000 Chrysler jobs in 1980 and 100,000 in 1981 would reduce the Federal deficit by $1 billion in 1980 and $1.75 billion in 1981, including additional revenues and reductions in unemployment claims, welfare costs and other payments. Based on assumption that the tenure of each job is three years, the Federal deficit reduction per job saved will be $13,333 per year or $40,000 over a three year period.

COST BENEFIT ANALYSIS OF REVENUE GAINS PROJECTED
RESULTING FROM AN INCREASE IN FUNDS AVAILABLE FOR INVESTMENT
DUE TO AN INCREASE IN CAPITAL GAINS EXCLUSION FROM 60% TO 80%

Revenue Loss (per job created)		Benefit (per job created)	
$25,000	Initial Investment (after tax dollars)	$12,480	Salary paid if job created paid $6.00 per hour
$10,000	Capital Gain (assumed average growth of 15% per year) [1]	$1,717	Federal Income Taxes
$2,800	Tax at Maximum present rate of 28%. [2]	$1,530	FICA Taxes (Employee and Employer)
$1,400	Reduction realized if 80% exclusion	$4,100	HEW figure on amount saved by not paying Unemployment Compensation and/or Welfare
$1,400	Maximum net revenue loss per job deferred for one to three years	$7,347 [3]	Amount realized by job created in the first year and each year thereafter.
		$22,041 [3]	Total for three years based on assumption that each job created last three years
			(If Secretary Miller's data were used this figure would be $40,000)

1/ Fifteen percent growth is above average for all business. For purposes of this paper we have used this high figure to maximize revenue loss.

2/ Actual figure would be lower because this is based on maximum, not actual rate. If average tax capital on gains and losses is used instead of minimum, net revenue loss would be $1,590. After raising the exclusion to 80% the loss would be $795.

3/ These figures do not take state income taxes or other relevant taxes into account.

The figures in the Cost Benefit Analysis Chart are far lower than those used by Secretary Miller and based on a more direct and easily discernible cost/benefit analysis.

Additional benefits would accrue by increased collections of fees and taxes on the business entity, and additional jobs created or supported to serve the primary job. E.g. each job in the automobile industry supports other jobs for the production of components and material that are assembled into the finished car. Thus if the multiplier ratio was 1:1, each unit of job creating capital invested would provide two jobs instead of one i.e., the primary job and the supported job. Government estimates have ranged as high as 3 to 1.

E. Revenue "Lost"

One method of analysis of Revenue "Lost" is to look at the most recent Treasury Department Statistics of Income, covering individual income tax returns for the year 1976, which show long term capital gains totalling about $35 billion for the year. 16/ The statement of Donald C. Lubick, Assistant Secretary for Treasury for Tax Policy, before the House Committee on Ways and Means on November 13, 1979 17/, indicated that close-held business interests and farms* represented 7 percent of the value of assets reported on estate tax returns. This 7 percent seems a reasonable estimate of the portion of capital gains realized on small business interests.

At 7 percent of total capital gains of $35 billion of maximum amount of capital gains eligible for the suggested tax reductions would be about $2.5 billion. The 1978 study by the Office of Tax Analysis showed an average tax rate of 15.9 percent on capital gains. 18/

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*/ While some small businesses are publicly held, these would be offset by large businesses that are privately held such as Cargill.

At 80 percent (the present preamble rate) of 15.9% or an estimated 12.7% effective rate on capital gains, the maximum initial revenue "loss" would only be $159 million.

Another method of assess revenue loss is to assume that the capital gain exclusion is raised to 80%. If this occurs the estimated revenue "loss" would be $3.5 billion (based on Joint Committee on Taxation projections on raising the exclusions from 50% to 60% in 1979).19/ Of that $3.5 billion, only 25% ($881 million) involves gains on corporate stock, approximately 20% of which would be small businesses. This revenue loss at most would amount to $176 million using 1979 figures.*

These losses (either $159 from the first computation method or $176 million from the second) might best be viewed as seed money which the Government will regain many times over at a handsome rate of return. And, the Government assumes zero risk by this investment in small business since it is a "partner" that shares only in the profits, not the losses.

F. Small Business Need For Capital

> It is a matter of acute concern that, in the face of clearly emerging needs and the documented benefits to the U.S. Economy, a set of impediments have developed that are preventing smaller businesses from attracting the capital without which they cannot perform their traditional function of infusing innovation and new computation into the economy. Unless these impediments are overcome, the ability of the economy to compete in the world and meet the needs of the American public will be seriously eroded. It is alarming that venture capital for new and growing small business has become almost invisible in America today.20/ (emphasis added)

* Any potential revenue loss would be deferred for 3 years if a minimum holding period for such investments were three years.

Steps must be taken to help small businesses with their financial problems so small businesses can in turn help the country with its employment, productivity and balance of trade.

The principal problems of small business have been described as acquisition of seed, start up, and expansion capital that they need, and secondly, the ability to retain sufficient earnings so they can plow it into the very rapid growth of their companies. The White House Conference on Small Business held in January of 1980 clearly identified the need for small business capital as a top priority.

Private partnership venture capital investments, which provided $20.2 million in 1977, increased to $215 million in 1978. Most of the 1978 investments were made in the fourth quarter of the year, after the Revenue Act of 1978 was either passed or seemed certain. It is estimated these venture capital investments will be $300 million in 1979. 21/ This $300 million, however, is quite small when compared to money raised by big business. IBM, in its October, 1979 issue alone, issued $1.5 billion of notes.

Another public source of capital for small business is public offerings of stock. New issues almost completely dried up in the years 1969-78; they declined from 1,298 in 1969 to 58 in 1978, a decline of over 95 percent. A major reason for this decline was the increase in capital gains taxes in 1969. However, when capital gains taxes were reduced in 1978, the first time in over 40 years, new issues increased to 59 over the first half of 1979. Total revenues obtained for small business (defined here as businesses with a net worth of less than $5 million) from new issues was only $129 million. 22/

This statistic becomes more meaningful when it is reduced to dollars. In 1978 the value of new stock issues was $4.7 billion dollars of which small business only received $129 million or 2.7%. 23/

This $129 million seems particularly paltry when compared with money raised by AT&T alone. In 1979, AT&T issued $1.7 billion in common equity to current stockholders and employees.

Further compounding the problem of inadequate capital is the lack of incentive to invest in small business. This lack of incentive is even more accute for innovative small business, a key to high productivity. The Joint Economic Committee in its Midyear Review of the Economy noted that since World War II, productivity in Japan grew four times faster than in the U.S. and two or three times faster in France, Italy, and West Germany. 24/

G. Existing Programs

The existing programs which have been designed to help small businesses have had some success but adequate capital requirements have not been reached. Equity investment is better for small business than debt financing because of the flexibility in repayment schedules.

The guaranteed loan programs of SBA, Farmer's Home Administration and the Economic Development Administration, although helpful, have fallen short of providing needed investment capital.

The tax cuts of 1978, while providing some relief, have not made adequate expansion funds available. Although a tax cut allows internal expansion through retained earnings, small businesses lag far behind their big business competitors in their ability to use this financing device. Profits must be high in order to have money

for retained earnings. This is demonstrated by the following figures taken from Treasury Department Statistics on Income, 1974, on the relationship of retained earnings of business receipts of various sized corporations. 25/

Total Assets	Percentage of Retained Earnings to Business Receipts
Under $100,000	zero
$100,000 to $250,000	8.9%
$500,000 to $1 million	10.3%
$1 million to $5 million	11.0%
$5 million to $10 million	14.2%
$10 million to $25 million	16.1%
$100 million to $250 million	19.5%
Over $250 million	25.5%

Earnings can be retained only after payment of income taxes, and here again small businesses do not do well. While manufacturing corporations with business receipts of $50,000 to $100,000 were paying total taxes of 30.1 per cent of their net worth, those corporations with receipts of $1 to $5 million were paying 19.9 per cent, and the giants with over $1 billion in receipts were paying 11.5 per cent.

This can be demonstrated clearly when we compare small business retained-earnings in dollars with all businesses. In 1974 small business had retained earnings of $8.9 billion 26/, while retained earnings for all business was $52.4 billion. This becomes more vivid when examining the increase in retained earnings in 1979 for Exxon and AT&T. Exxon's retained earnings increased by $1.3 billion and AT&T's by $2.1 billion in one year. These two

corporations retained more than 10 times the estimated total venture capital investments in small business during the same time period.

CONCLUSION

Times have changed. Small business' concerns are no longer just the concerns of small business -- they are the Nation's concerns. The small business sector of the economy is so intrinsic to the Nation's economic health that we must act to strengthen, rather than weaken it.

With the prime interest rate well over 10 percent and recently over 20 percent, tradititional methods for capital formation in small businesses must also change. Small business loans or loan guarantees can no longer meet the demand for small business capital and small business can no longer pay the price for money even when it is available.

The need for additional equity capital for small business has been a problem for a long time, but it is critical now. General reductions in capital gains taxes have resulted in some additional investments in small business but they have fallen short of hoped for funds. Investments in real estate and large business have risen but have little or no job creation potential and have drained off benefits from increased capital investment which could have flowed to small business. */

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*/ The approach to reduce capital gains for small business investment has support from the White House Conference on Small Business, Senator Gaylord Nelson (S. 1860), the SBA Advocacy Task Force, the Commerce Job Creation Work Group, the Commerce Innovation Small Business Task Force, and the Subcommittee on Antitrust, Consumers and Employment of the Committee of Small Business of the House of Representatives in its report entitled "Future of Small Business in America."

The initial approach of this paper was to follow S.1860 and H.R. 5607 which proposed a reduction in capital gains taxes for innovative small businesses only. However, after a determination that the revenue loss from the tax reduction would be so low, the analysis was expanded to encompass all small business. Based on the 16 to 1 benefit to cost ratio, the deferral of any loss to the Treasury for three years and the established need for increased equity capital, a decision to reduce capital gains taxes on earnings from small business is a wise one. No other proposal to bolster small business will have such an enormous impact on maintaining a healthy economy.

FOOTNOTES

1. MIT Study for Department of Commerce on "The Job Generating Process," David L. Birch, February 1979.

2. Study conducted by Honorable John B. Breckinridge, "Future of Small Business in America." Report of the Subcommittee on Antitrust, Consumers and Employment, Committee on Small Business, U.S. House of Representatives, 95th Congress, Second Session.

3. "Small Firms and Federal Research and Development (R&D)": Joint Hearings on Small Business and Innovation before the Senate Committee on Small Business and the House Subcommittee on Antitrust, Consumers, and Employment; and on Energy, Environment, Safety and Research of the House Committee on Small Business, 95th Congress, Second Session 452 (August 1978). (Background to OMB Report of March 10, 1977 and based on study conducted by William K. Sheirer, Consultant.)

4. Ibid at 526.

5. National Science Board, National Science Foundation, Science Indicators for 1976, at 118 (1977).

6. Joint Hearings on Small Business and Innovation, supra note 3, at 594-606.

7. SBA Survey on Job Creation: Hearings on Small Business and Job Creation before the House Subcommittee on Antitrust, Consumers, and Employment of the House Committee on Small Business, 95th Congress, Second Session 511-521 (September 1978). Testimony of Harold A. Teiste, Assistant Administrator for Planning, Research, and Data Management, SBA, p. 251.

8. Ibid at 367, testimony of Robert Butler, Assistant Administrator, Business and Industrial Loans Program, Farmers Home Administration.

9. Ibid at 238, testimony of Edward A. Trautz, Chairman, Federal Legislative Committee, Independent Bankers Association of America.

10. Ibid at 330, testimony of George T. Karras, Deputy Assistant Secretary for Economic Development Operations, U.S. Department of Commerce.

11. Investment Management and Evaluation Division of the Office of the Investment Division, Small Business Investment Companies, Evaluations of Small Business Concerns, at 5,7,18 and 19 (January 1980).

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12. The figure is based on the Department of Health, Education, and Welfare and Department of Labor averages for the cost of Aid to Families with Dependent Children and Unemployment Compensation respectively. At the 1979 rates, if a person collected Unemployment Compensation for thirteen weeks (an average period of collection at an average rate of $89 per week) and then collected AFDC and Food Stamps payments for the remainder of the year (9 months at an average of $343 per month) the total for the year would be $4,254. These figures are corroborated by a study entitled "Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives" Congress of the United States, Congressional Budget Office, September 2, 1975 in which they estimated the budget costs of maintaining a person on Unemployment Compensation for one year is $3,250. Adjusted upward to reflect 1980 rates, $4,100 is a fair estimate.

13. See Edward Sekscenski "Job Tenure Decline as Work Force Changes," Monthly Labor Review, December 1979, Vol. 102, No. 12 and Testimony of Secretary Miller, infra.

14. Capital Gains Tax Bills: Hearings on S. 3065, S. 2428 and S.2608 before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, 95th Congress, Second Session (June 1978). (Statement of the Honorable W. Michael Blumenthal, particularly Table 1.)

15. Federal Loan Guarantees for Chrysler Corporation: Hearings before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, 96th Congress, First Session (1979). (Testimony of the Honorable G. William Miller).

16. Treasury Department Statistics on Income, Individual Income Tax Returns, 1976.

17. Tax Treatment of Appreciated Property Passing at Death: Hearings on H.R. 4694 before the House Committee on Ways and Means, 96th Congress, First Session (November 1979). (Statement of Donald C. Lubick).

18. Hearings on S. 3065, S. 2428 and S. 2608, supra note 21, at Table 1.

19. Joint Committee on Taxation, 96th Congress, First Session, General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Congress; Public Law 95-600) 23. (Joint Committee, Print 1979).

20. SBA Task Force on Venture and Equity Capital for Small Business, SBA, Report at 1 (Introduction) (January 1977).

21. Rowe, Jr.,"Firms Hunt Funds Off Wall Street," Washington Post, November 18, 1979, Section G (Business and Finance), at 1, Column 1.

22. Ibid, Section G at 3, Column 1.

23. Ibid, Section G at 3, Column 1.

24. Joint Economic Committee, 96th Congress, Second Session, Report on the January 1980 Economic Report of the President 68. (Joint Committee, Print 1980).

25. Treasury Department Statistics on Income, Corporation Income Tax Returns, 1974, Table 4, at 36-37.

26. Ibid, at 36-37.

SBA'S ROLE AS AN ECONOMIC STIMULUS VEHICLE (JOB CREATION)

"IT'S BETTER TO LEND THAN TO SPEND"

RATIONALE

At the direction of the Administration and in support of announced Presidential priorities and objectives, the Agency recently completed a study which clearly indicates that the existing programs of the Small Business Administration, given the resources and with minor program modification, are capable of playing a major role in economic stimulus and job creation.

Considering the Administration's goals to reduce unemployment by creating jobs, stimulate the economy, control inflation and move towards a balanced budget, SBA has concluded that it can make a significant contribution to the attainment of these goals.

Such a course is indicated for the following reasons:

1. The stimulus would involve loan funds which would be repaid - not grants which are budget outlays with no direct payback. The net result would be a plus factor with the Federal Government receiving more than it invests. "It is better to lend than spend."

2. Jobs created would be more permanent than public service and public work jobs. Jobs would be created with a plus benefit to the Government; public sector jobs represent a minus factor.

3. The impact of the budget would be minimal since only the repurchase reserve (now 15%) appears initially as an outlay.[1] This goes to the Presidential objective of balancing the budget while at the same time achieving job creation.

4. Small business is more labor intensive than big business.

5. SBA programs represent a direct injection into the economic mainstream. Approximately 3 months are required for SBA loan funds to enter the economy.

   It is important to remember that economic stimulus by SBA involves private sector dollars - not public sector collars. The use of private sector dollars that are repaid is the most viable and fiscally responsible method of achieving a stable economy based on employment in the private rather than the public sector.

SBA believes that the implementation of the recommendations incorporated in this position paper will create jobs, stimulate significant economic activity, help controlling inflationary factors, aid in balancing the budget and strengthen our competitive free enterprise system. Such a program will be responsive to President Carter's pledge "to allow small business viable sources of financing on a parity with big business."

[1] After recovery efforts, the Agency's net loss currently approximates only 3.02% as there is a 70% recovery on those loans repurchased.

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BACKGROUND

Representing close to 97% of the Nation's business entities, SBA's constituency of 13+ million business persons and farmers is second only to that of organized labor. Small businesses generate nearly half of the private sector Gross National Product and over half of all business receipts and MOST IMPORTANT, they employ more than half of the Nation's business work force.

SBA's ongoing economic impact involves loans which are repaid rather than grants which have no direct monetary payback. The Agency is already playing a vital role in the free enterprise system including a direct and productive ongoing relationship with the private sector. SBA is the only Federal Agency which emphasizes and has ongoing active financial programs to fulfill the needs of minorities and women in business. Loans to members of minority groups total approximately 53,000 with total dollars in excess of $1 billion. SBA has recently targeted $100 million (1st quarter of '78) for guaranteed business loans to women.

Given this background, SBA is an obvious instrument for increasing employment opportunities. The approach has the merit of making maximum use of private resources and the free enterprise system itself. Competitive market forces will operate freely in channelling small businesses credit into its most productive employment. Since most small businesses are labor intensive, this approach provides more employment per dollar of expenditure[2] than alternative approaches that would provide incentives for increased investment in capital intensive industries. Additionally, this proposal will provide credit needed by small, high technology concerns for rapid growth and job creation. Finally, this approach creates jobs through expanded investment, which creates permanent values and continued employment.

[2] SBA's internal Cullen Report and Venture Capital Study indicates that the Agency's job creation programs actually result in no cost but instead net revenue to the Treasury.

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CARTER ADMINISTRATION'S LONG TERM ECONOMIC STRATEGY

"Remarks of W. Michael Blumenthal Secretary of the Treasury at the Annual Convention of the American Bankers Association" -- 10/19/77

"We find today, for example, higher than acceptable levels of inflation and unemployment existing side by side seemingly impervious to tried and true remedies of the past."

"The first principle is that the private sector is the key to the health of the U. S. Economy."

-- SBA is already playing a vital role in the free enterprise system - with a close and productive ongoing relationship with the private sector. The Agency, with a 70% increase in 1977 loan demand, seeks the Administration's commitment to significantly expand its guaranty loan program as well as to provide for the availability of venture and equity capital for the small business community. SBA can move boldly to develop private sector jobs - jobs with a FUTURE - by working in close concert with private sector commercial lenders on the one hand and venture capitalists on the other.

"Our second principle is that government must concentrate on increasing the rate of private capital formation."

-- SBA is prepared to actively engage in the private capital formation objective by expanding the 7(a) Guaranty Program, establishing a more viable and responsive secondary market and intermediate lenders and providing venture capital via the recommendations set forth herein.

"Our third principle is that government policy must provide a stable, predictable environment for business planning."

"Our fourth principle is that government must learn to work with, not against, the business sector in moving the economy away from high inflation and high unemployment."

-- SBA knows through working closely with the private sector in terms of economic stimulus, that it can create a stable predictable environment so vital to the PRIVATE sector. In many areas, SBA has already established candid and open communication with key elements of the private sector. Where this foundation has been built - it is solid. The Agency merely seeks the resources to expand it, efforts and thereby achieve the aforementioned economic objectives of the Administration.

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CONGRESSIONAL ATTITUDES

Congress is generally supportive of increased appropriations and lending authority for the Small Business Administration.

One of the frequent complaints from Senators and Representatives is that there are many small businessmen who cannot secure loans and it is frequently suggested that SBA ask for additional funds to expand its financial assistance programs. There is a general attitude on the Hill favorable to small business and increased financial assistance for small business.

The Congressional Rural Caucus, which includes 91 Members of Congress from rural areas, has played a major role under the leadership of Representative John Breckenridge (D-Ky.), a member of the House Small Business Committee, in developing and promoting the concept of expansion of SBA (and Farmers Home Administration) lending programs to stimulate the economy and create jobs, as an alternative to job creation through public works and public works grants.

The heavy emphasis by Breckenridge and other Members of the Caucus is that the impact of such a program on the budget would be minimal, and yet job creation would be stimulated in the job intensive small business sector.

Urban Congressmen and Senators have also indicated an interest in expanded SBA programs and have expressed concern over the relative number of small business persons reached by SBA lending programs each year.

PROJECTION: The economic stimulus proposal outlined in this document would be acceptable to more than a majority of the Members of both Houses. Many would enthusiastically support the proposal.

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THE ECONOMIC SIDE OF SMALL BUSINESS

Four of the broad policy objectives of the Administration and of long-run economic policy are to increase employment, accelerate economic growth and stimulate investments and control inflation. Given the means the Small Business Administration will contribute positively toward achieving these goals in that:

-- Its impact would be to create private sector jobs and likewise utilize the private sector for funding.

-- Its programs assuming 3 year tenure in job creation have a positive payback to the Government.[3]

-- Its use of labor per dollar of investment in most instances proportionately greater than that of large business because small business is relatively labor intensive.[4]

The stimulation of business investment, in addition to the increase of consumer demand, is expected to be important as a means of reducing unemployment. Because of the severity of the recent recession and current inflation, improvement of the sales, cash flow and undistributed earnings of small manufacturers is known to have been slower than changes for large firms. Recovery of the profit situation of small businesses in other industry activities probably has been rather similar. Therefore, if monetary policy dictates a very moderate (or restrictive) rate of growth in the money supply to stabilize prices, small businesses which often are considered to have marginal financing opportunities may experience difficulty in obtaining adequate funds until price stability is achieved during the economic recovery. Generally small businesses have very limited access to capital markets and offer relatively uninteresting investment opportunities for the banking community.

SBA deals in an environment that not only involves high technology but also is labor intensive. It cannot be overemphasized that the Agency's job creating tools involve repayment and in the long run -- profits. No other Agency or Department can provide repayable and profitable programs that stimulate our economy to such a degree.

SBA'S NEW ECONOMIC STIMULUS

The recently approved Neighborhood Business Revitalization Pilot Program is designed to stimulate commercial and industrial small business revitalization in declining but viable urban neighborhoods, towns and rural communities. This new thrust creates jobs, strengthens existing small

[3] U. S. Department of Labor - Job Tenure of Workers, January 1973 p. A-9 indicates that the average tenure for private sector employment is 3.9 years.

[4] SBA's Cullen Report indicates that for every 10,000 in SBA guaranteed loans, one job is created (see Appendix I).

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businesses, creates new small business enterprises, provides necessary community business and professional services, improves real property values, and reinforces community stability and economic health.

Acting as a catalyst, SBA seeks to cause interrelated, long-term investments by both the public and private sectors. The public investment, including public service improvements, is sought on the basis of public policy. Private investment is attracted by the use of SBA's authority to guarantee private sector loans.

SBA guaranteed private sector financing of small business revitalization minimizes direct government expenditure while satisfying critical national and local needs. The Program dovetails with other Administration programs to create jobs, rebuild the cities, and strengthen local economies in both urban, suburban and rural areas. Special efforts are built in to create and preserve minority employment and to sustain minority business growth.

Local community initiative and leadership, participation by the local financial institutions, and public facility and service improvements by the local government are necessary to program success. Neighborhood small business revitalization is most successful when concurrent action is taken to revitalize the adjacent residential area. Residential rehabilitation creates additional jobs and small business contractor opportunities.

Pursuant to Section 7(b)7 of the Small Business Act, and in an effort akin to that of Neighborhood Business Revitalization SBA has engaged in the lead role in job retention and creation and revitalizing the local communities effected by the closings of military installations. SBA has helped retain or create 15,898 jobs in defense impacted communities.

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SBA SURVEY ON JOB CREATION

In July 1977, SBA at the request of the Administration and Congress designed a statistical survey of its Fiscal Year 1976 business loan borrowers in order to responsibly determine the relationship between SBA's business loan programs and job creation (See Appendix I).

The results of the survey were as follows:

-- On an average each $10,000 in loans made to a small business creates one new job slot.

-- In addition to the creation of a new job, each $10,000 in loans maintains approximately three jobs.

-- The average salary of the small business employees in 1976 was approximately $6,000 which compares reasonably with median per capita income for that year and the average salary and wages of employees in retail trade and services -- areas of major small business activity.

-- A sound statistical basis was established for the Agency to proceed with a cost-benefit analysis of SBA's programs and their related impact on employment, job creation and economic stimulus.

COST/BENEFIT ANALYSIS OF AN SBA ECONOMIC STIMULUS EFFORT

Utilizing the results of the Survey on Job Creation, the Agency prepared a Pro Forma Cost Benefit Analysis (See Appendix II) which clearly illustrates the effect of accelerating SBA's business loan program in an increment of 100,000 jobs at $10,000/job or $1 billion in either increased federal guaranteed funding or direct funding to small business.

In preparing the Pro Forma Cost Benefit Analysis on both programs, costs were measured over the average 7-year life of an SBA loan; savings and revenue were conservatively measured over a 3-year job tenure for a new position created. Estimates of job creation also are discounted to allow for a transfer of a portion of total employment generated by SBA loans from alternate forms of employment. Thus, the maximum level of job creation is set at 100,000 persons or $1 billion in loan money with an average of $10,000 loan value per job created. The minimum figure is related to past findings of the Congressional Budget Office concerning the proportion of job creation which would be drawn from the ranks of the unemployed. 5/

5/ Congress of the United States, Congressional Budget Office, Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives, September 2, 1975, p. 4.

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This lower job creation figure was further discounted to provide a conservative estimate of 45,000 new jobs generated by SBA business loans.

The results of the cost benefit analysis are summarized in the following table:

	SBA GUARANTY LOANS		SBA DIRECT LOANS	
	High	Low	High	Low
Jobs	100,000	45,000	100,000	45,000
Net Revenue	$659.1M	$252.6M	$508.9M	$102.4M
Net Revenue/Jobs	$6,591	$5,613	$5,089	$2,276
Annualized Return on Investment for 3 Years	286%	130%	108%	48%

Over a 3-year revenue cycle and the 7-year cost cycle, the high level of employment through guaranty loans should generate a total revenue of $745.9 million with a cost of $86.8 million. Utilizing the private sector (guaranty loans), it would require minimum Treasury outlays to be recaptured through Federal income taxes, savings in unemployment compensation and welfare payments and guarantee fees. Net revenue would amount to $659.1 million or $6,591 per job created. At a low level of job creation, the guaranteed program would generate revenue of $339.4 million with costs of $86.8 million and revenue of $252.6 million or $5,613 per job.

At the upper level of job creating -- 100,000 -- SBA direct loans will generate $737.4 million in total revenue and will cost $228.5 million over the 7-year maturity period. Net revenue will amount to $508.9 million or $5,089 per job. At the low level -- 45,000 -- net revenue will be $102.4 million or $2,276 per job.

Although the SBA guaranty program shows the greatest return on investment from a high of 286% to a low of 130% per annum, the Agency's direct loan program also shows a positive return on investment from a high of 108% to a low of 48%. This differentiation is made inasmuch as direct funds are much more easily targeted than guaranty funds and that the Agency not the private sector, is the major decision maker in the loan process.

COMPARISON WITH OTHER EMPLOYMENT PROGRAMS

SBA has been unable to compare its proposed loan package with other programs for employment stimulation or support of the unemployed. Published impact data for other programs are derived by various estimating

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techniques which have been revised over time and which sometimes employ the use of econometric models in developing estimates. The Agency, therefore, needs information for other programs which can be cast into our own model. To date it has not been possible to obtain these statistics and currently no assumptions can be made concerning the future availability of such figures. However, a reasonable degree of comparability may exist in SBA and other program estimates of the impact of their employment stimulus in reduction of the unemployment rate.

In 1975 the average unemployment rate was 8.5% (8.45%). That same year the Congressional Budget Office estimated the initial rate reduction of selected programs costing $1 billion as follows: [6]

- Public Service Employment	.07 - .11	
- Anti-recession Aid to State and Local Governments	.04 - .07	
- Accelerated Public Works	.02 - .04	
- Tax Cuts	.01 - .02	(1/3 Corporate - 2/3 Personal)
- Government Purchases	.02 - .04	

At the low and high levels of employment (45,000 and 100,000) the SBA $1 billion injection in 1975 might result in a reduction of from .03 to .06. This translates to an impact of 8.45 - .03 = 8.42 and 8.45 - .06 = 8.39. These estimates are based on an arbitrary assumption that only six of every ten persons employed under SBA's economic stimulus will represent a true reduction in unemployment and the others might come from other job alternatives.

Each of the above programs calls for expenditure of $1 billion as compared to the SBA program which calls for lending (and return to the Treasury) of $1 billion or "IT'S BETTER TO LEND THAN SPEND."

[6] Congress of the United States, Ibid, p. 69

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CONCLUSIONS AND RECOMMENDATIONS

GUARANTY LOAN PROGRAM

SBA's Guaranty Loan Program is one of the Government's most cost efficient and in reality will result in a net payback to the Government. However, an effective change to a private sector form of economic stimulus and job creation over a phased 5 year program, is suggested, whereby, the private sector and SBA may lay the ground work for sound stable economic growth while maintaining a reasonable loan loss ratio. Below is a recommended phased growth projection for accelerating SBA's guaranty loan program:

Fiscal Year	Dollars Loaned	Additional SBA Personnel Resources		Jobs Created (Thousands)
		Increment	Total	
1979	$5 billion	(+2,335)	2,335	220 - 500
1980	$7.5 billion	(+1,168)	3,503	330 - 750
1981	$10 billion	(+1,167)	4,670	440 - 1,000
1982	$15 billion	(+2,335)	7,005	660 - 1,500
1983	$20 billion	(+2,335)	9,340	880 - 2,000

DIRECT LOAN PROGRAM

In order to maintain the Agency's mandated commitment to all small businesses, and the Administration's ability to best target funds to areas of high unemployment (like Youngstown, Ohio), it is necessary that SBA continue its direct loan efforts to accommodate the needs of those entrepreneurs who truly cannot obtain financing through normal lending channels or to communities caught in an economic disaster.

With the provision of reasonable direct fundings, the Agency finally will be able to promote and market its lending programs. Too often, in recent years, promotional efforts have backfired because SBA could not deliver due to a lack of two all important resources - dollars and personnel.

Finally, if necessary, direct government financings could well be utilized in a counter cyclical manner to provide continuity of economic stimulus (job creation) during periods of tight money or in the event of an economic downturn.

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Below is a recommended phased growth projection for accelerating the direct loan program representing 10% of the guaranty program growth:

Fiscal Year	Dollars Loaned	Additional SBA Personnel Resources		Jobs Created (Thousands)
		Increment	Total	
1979	$500 million	(+623)	623	23 - 50
1980	$750 million	(+312)	935	34 - 75
1981	$1 billion	(+312)	1,247	45 - 100
1982	$1.5 billion	(+623)	1,870	68 - 150
1983	$2 billion	(+624)	2,494	90 - 200

IMPLEMENTATION

Upon approval of the above recommendations, SBA will take immediate steps to begin implementation of its new role - ECONOMIC STIMULUS. The modifications and procedures established will be closely related to the overall reorganization concepts within SBA. Some of the actions and modifications are as follows:

- Once the resources - dollars and people - are committed, the Agency will engage in extensive PROMOTION EFFORT. SBA will promote its lending programs in general and the guaranty program in particular. Special emphasis will be placed on establishing working relationships the bankers associations, trade associations, local chambers of commerce, etc.

- Both the Agency and its clientele are presently overburdened with complex and confusing statutes, extensive regulations and procedures and multiple sets of criteria that must be met before obtaining and using loan proceeds. SBA will, therefore, CONSOLIDATE its numerous lending programs in order to more effectively deliver financial assistance (see Appendix III).

- In order to provide job creating potential to the fullest extent, it will be necessary to seek legislation enabling SBA to raise the LOAN and MATURITY ceilings. For specific economic stimulus loans to be made under closely controlled criteria, no legal limit will be imposed and maturities will be raised to 30 years - consistent with Department of Agriculture's Business and Industry Program. (See Appendix IV).

- Any major expansion of the guaranty program will require substantially increased involvement and interest by participating lenders. Given the nature of the Nation's commercial loan portfolio; it is opined that there will be a need for intermediary lending outlets - SMALL BUSINESS LENDING COMPANIES. The SBLC is created under SBA regulations and operates for the sole purpose of making SBA guaranteed loans.

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- The Agency's SIZE STANDARDS need a complete overhaul. It is the intent to completely revise said standards and develop a simplified definition of Small Business that is both readily understandable and equitable to the American business community for the lending and procurement activities.

- As currently operated, the SECONDARY MARKET is overly fragmented and the cumbersome nature of the transfer system reduces the free movement of investments within the market place. To support increases in guaranty loan activity, it is essential that a smoothly functioning secondary market be available. To accommodate this vital need, SBA will establish a centralized transfer and paying system as well as a certificate of ownership which can be freely traded. (See Appendix V).

- The Agency will conduct an in depth efaluation of the piloted NEIGHBORHOOD BUSINESS REVITALIZATION program so as to utilize same as one of the major lending mechanisms for SBA's overall economic stimulus thrust. Closely following the reorganization concepts, the delivery mechanism will provide for constant communication between SBA field personnel and the various elements of business and socio-political leadership in the local communities across the nation. The delivery system will be most effective with local SBA personnel (team concept) working closely with local businessmen and community leaders.

ECONOMIC IMPACT

The above estimates of jobs created show that by 1983 the low and high range of employment generated from the business loan programs would be as follows:

Guaranty Loan Program	$20 billion	880,000 - 2,000,000 jobs
Direct Loan Program	$ 2 billion	90,000 - 200,000 jobs
	Total	970,000 - 2,200,000 jobs

The low range of job creation would average almost 23,000 per job while the high level would be 10,000.

Due to SBA's proposals to revise size standards, loan levels, etc., the average loan investment per job may increase somewhat. SBA's increased loan participation in such areas of industry as construction and manufacturing may also tend to raise the average investment level.

In September 1977, unemployment and the unemployment rate (seasonably adjusted) for the civilian labor force were as follows:

Labor Force	97,868,000
Unemployment	6,773,000
Unemployment Rate	6.92

If the SBA low and high levels of job creation by 1983 are related to the September 1977 figures the change in the unemployment rate would be as follows:

Low Level	6.92 - .59 = 6.33
High Level	6.92 - 1.35 = 5.57

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APPENDIX I

SURVEY OF SBA BUSINESS BORROWERS FOR FISCAL YEAR ENDING JUNE 30, 1976

SBA JOB CREATION - THE CULLEN REPORT

One of the major problems in formulating opinions if the job creation potential for the SBA loan programs has been a total lack of reliable statistics on the degree to which the loans have been used by borrowers to create jobs as opposed to job maintenance. Employment information extracted from the SBA loan approval documents has shown a combined figure for jobs which borrowers expect to be created from loans and the number which they would maintain.

In July 1977, SBA initiated plans to conduct a sample survey of its business loan borrowers to develop information which would measure changes in borrowers employment, payroll, sales and assets prior to the loan approval date and one year after that date. The focus of the survey was on the change in employment from the date of loan approval to one year later and on the number of jobs created as opposed to maintained. The jobs created later gave the cost of a job per dollar of loans approved, and the remainder of the information was to be used primarily to estimate cost-benefit aspects of an expanded program.

Sampling Frame and Procedure

The sample was drawn from the computer records on SBA business loans approved in Fiscal Year 1976. Distribution of the approvals and number of employees by employee-size of classes of borrowers were as follows:

Employee Size Classes	Loan Approvals		Employees	
	Number	Percent	Number	Percent
0 - 3	11,914	45.8	21,519	7.5
4 - 6	4,878	18.8	23,580	8.2
7 - 12	3,829	14.7	35,370	12.3
13 - 24	2,700	10.4	46,985	16.3
25 - 48	1,668	6.4	55,487	19.2
49 - 99	709	2.7	46,169	16.0
100 - 249	272	1.1	37,715	13.1
250 - 500	30	0.1	9,982	3.5
501 and Over	6	*	11,235	3.9
Total	26,006	100.0	288,042	100.0

The design and size of the sample were determined with the assistance of the Bureau of the Census. SBA selected a sample option which included a total of 441 cases and was stratified by employee-size of borrower. The sample contained all of the 308 establishments with 100 or more employees and a stratified sample of 133 establishments from the remaining 25,698 establishments with 99 fewer employees. Under the sample design the true proportion of change (P) from FY 1976 to FY 1977 was assumed to be around 10 percent with an error of 10 percent of (P) and a confidence level of 95 percent.

Survey information was collected by telephone by SBA field employees, and employment data were obtained from 335 cases or three-fourths of the total. The majority of the cases for which information was not available represented

* Less than .05 percent

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loans which were cancelled after approval and sometimes following initial disbursements and companies in liquidation.

Survey Findings

According to the returns of the SBA borrowers survey, jobs created approximately one-fifth of the total positions which were created and maintained by the business loan program. In deriving this ratio declines in the number of jobs from the FY 1976 employment levels to the FY 1977 levels were regarded as negative creation which were subtracted from the total number of jobs created. The portion of employment which was regarded as maintained did not always include all employees who were on payrolls at the date of loan approval. Maintenance data reported by borrowers sometimes represented only a portion of the total employment which was affected by the SBA loan.

The survey indicates that on an average each $10,000 in loans to small business creates one new position and additionally, maintains approximately 3 positions. As this is the first survey of its kind to be conducted by SBA, the Agency has no prior information for comparative use on cost of job creation. However, initial evaluation of the survey returns suggests the job creation aspects of findings are reasonable. The cost of loan dollars per job created tends to be low -- approximately $10,000 per job. In 1975 the Congressional Budget Office in discussing public service employment noted that the cost of jobs created by those programs, might be as low as $8,000 because the preponderant number of new employees would be unskilled and receive low wage rates.[7] A very substantial portion of the SBA loan created jobs also might be among workers who are not highly skilled and receive relatively low salaries and wages. FY 1976 loan approvals are distributed by major industry divisions as follows:

Major Industry Division	Loan Approvals Number	Percent	Amount of Approvals ($000)	Percent	Average Value of Approvals ($000)
Agriculture	482	2	37,974	2	79
Mining	87	0	14,435	1	166
Construction	1,594	6	123,577	6	78
Manufacturing	3,715	14	464,330	22	125
Transportation	838	3	68,489	3	82
Wholesale Trade	2,767	11	297,103	14	107
Retail Trade	11,203	43	707,871	34	63
Finance	169	1	16,701	1	99
Services	5,087	20	324,420	15	64
Other	136	1	9,733	0	72
Total	26,078[8]	100	2,064,637	100	79

[7] Congress of the United States, Congressional Budget Office, Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives, September 2, 1975, p. 52

[8] Totals from different SBA tabulations vary slightly.

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APPENDIX II

PRO FORMA COST BENEFIT ANALYSIS
1 Billion Dollars of Loans and 100,000 New Jobs

	SBA Guarantee Loan Program		SBA Direct Loans	
	High	Low	High	Low
JOBS CREATED	100,000	45,000	100,000	45,000
	In Millions			
REVENUE GENERATED:				
Federal Income taxes received	150.0	$67.5	$150.0	$67.5
Savings in unemployment compensation and welfare payments	587.4	263.4	587.4	263.4
Guarantee fees	8.5	8.5	-	-
Total Revenue	745.9	339.4	737.4	330.9
COST OF THE PROGRAM:				
Administrative cost	36.8	36.8	107.7	107.7
Estimated chargeoff (loss)	50.0	50.0	100.0	100.0
Interest (subsidy)	-	-	20.8	20.8
Total Cost	86.8	86.8	228.5	228.5
NET REVENUE	$659.1	$252.6	$508.9	$102.4
NET REVENUE/JOB (Whole Dollars)	$6,591	$5,613	$5,089	$2,276
ANNUALIZED RETURN ON INVESTMENT FOR 3 YEARS	286%	130%	108%	48%

Note: See next page for basic assumptions.

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BASIC ASSUMPTIONS

This analysis excludes any indirect or multiplier effect on jobs created or cost benefits to the Government. It does not include social security contributions of employers and employees, payments for unemployment compensation and payments of corporate income taxes.

Jobs Created: High - The estimate of 100,000 jobs created was based on results of a statistical survey designed by the Bureau of the Census on SBA Business Borrowers for Fiscal Year Ending June 30, 1976. A $10,000 value of loans per job created was derived from the actual reports of borrowers. These returns were considered to provide a higher loan cost and more conservative estimate of jobs created by SBA loan dollars than the survey very likely will produce. Borrowers with 100 and more employees were included in the survey with certainty and appear to generally have had a higher loan dollar requirement per job created than the smaller concerns which comprise the noncertainty stratum. This probably results from the fact that the great majority of SBA borrowers are both small in employee size and are in retail trade and services which have relatively low loan requirements per job.

Jobs Created: Low - The low for jobs created was related to an assumption that a proportion of the total would come from the unemployed portion of the labor force or indirectly would alleviate unemployment in the labor force rather than be a total transfer from alternative uses. The following statement concerning the relationship of job creation and unemployment was published in the Congressional Budget Office report, Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives, September 2, 1975, p. 4: "For the economy as a whole, as ten new jobs are created, six are filled by unemployed persons and four by persons not previously seeking work." More recently, this estimate was revised to seven of ten from the unemployed. The Agency in its analysis used a more conservative estimate by further reducing the low level for job creation by another 25 percent--from 60,000 to 45,000.

Revenues Generated: Federal Income Taxes Received estimates were based on data from the SBA borrowers survey which showed an average payroll per individual of approximately $6,000 and Internal Revenue Service data which showed that the average individual income of $6,000 per year generated $561 in Federal income taxes. The SBA average borrower's salary and wage figure coincided reasonably with the $6,002 median individual income figure for 1976 which was published in the Bureau of the Census report, Money Income and Poverty Status of Families and Persons in the U.S.: 1976, Series P-60, No. 107. The IRS figure of $561 was published in Preliminary Statistics of Income 1974, Individual Income Tax Returns was conservatively rounded for this analysis to $500 per individual. A job tenure of three years was assumed.

Savings in Unemployment Compensation Welfare Payments was based on an average of $3,250 in unemployment compensation which was published by the Congressional Budget Office in Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives, September 2, 1977, p. 70. That portion of job creation which would come from either welfare

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or unemployment compensation recipients was estimated at 60 percent of the high and low levels established for job creation. The annual unemployment benefits were estimated conservatively to extend over a three-year period. The Department of Labor Special Labor Force Report 172, Job Tenure of Workers, January 1973, lists the median tenure of both sexes on a job as 3.9 years. SBA had no means of estimating the proporation of job creation from the unemployed sector which would come from persons on unemployment compensation and welfare, but the $3,250 CBO unemployment figure is compatible with the levels of payment for the two groups. According to the Office of the Assistant Secretary for Planning and Evaluation, HEW, an average monthly payment for families on all types of welfare would approximate $250 per month or $3,000 per year.

Guarantee Fees: Guaranteed fees were estimated at slightly less than the one time rate of 1 percent earned by SBA on loans guaranteed to financial institutions.

Administrative Cost: Administrative cost was estimated at 150 percent of the prevailing cost to provide adequately for future cost increases and miscellaneous expenses.

Estimated Chargeoff: The historic chargeoff rate for the guarantee loan program is 3.02 percent and for the direct loan program is 6.6 percent. However, on the assumption that an accelerated loan program would be accompanied by a higher loss level, these chargeoff rates were increased to 5 percent and 10 percent, respectively.

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Appendix III

CONSOLIDATION OF LOAN PROGRAMS

SBA, the Government's focal point for assistance to more than 12 million small businesses, believes that its statutory lending authority and its implementing regulations can and should be simplified and consolidated in order to more effectively deliver financial assistance.

At its origin 24 years ago, SBA was charged with two loan programs (business loans; physical disaster loans). Over the ensuing years, as apparent needs arose, the Congress amended the statutes to add new and specific loan programs until today SBA has 19 statutory loan programs, plus the SBIC program.

Most of the "additional" loan programs could have been handled under previously existing statutory authority; apparently there was a perceived need for special authority to give special visibility and emphasis to such loans. Under some of the additional programs loans can be for up to 30 years and are unlimited as to dollar amount. Other of the additional loan programs expanded SBA's authority or expanded the SBA loan market by changing the criteria.

Each of the statutory additions precipitated an additional regulation, a development of new and separate program criteria, additional SOP provisions, and in some cases, additional forms and other paper requirements.

Today, SBA and the public are faced with rather complex and confusing statutes for our loan programs, extensive regulations and SOP's, and multiple sets of criteria for obtaining and using the loan funds. This unnecessarily burdens those receiving and those delivering SBA financial assistance.

The President has made commitments to reduce fragmentation of programs, to reduce paperwork and to improve delivery of assistance to small business. SBA should offer a specific means to help to accomplish these goals.

The President has stated his desire to bring the many small business assistance programs together into SBA. SBA should prepare for the result of such reorganization by clarifying, simplifying and consolidating its existing programs. We should seek to have our statutory authority broadened enough to permit us to absorb additional small business assistance programs without having to further encumber our presently-cluttered statutes.

The President is also committed to increasing the number of jobs available to Americans. One of SBA's primary job-generators is its financial

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assistance programs for small business. In order to improve and accelerate such assistance, SBA should propose simplification of its statutory authority and of the various elements of implementing that authority.

The importance of effective support of small business to the national economic health and creation and maintenance of jobs is illustrated by the fact that nearly half of the private sector GNP is generated by small businesses, that more than half of all business receipts are generated by small businesses, and that more than half of the Nation's business work-force is employed by small businesses.

Due to the various amendments we presently have 19 different loan programs, in addition to the physical disaster loan program, some of which are similar but others of which have varying provisions concerning lending limits, interest rates and terms.

The basic program differences are:

A. 7(a) - Regular Loan Program

(1) Direct and immediate participation loans limited to $350,000.

(2) Guaranty loans up to $500,000.

(3) Direct and immediate participation interest rate set by statutory formula - presently 6-5/8%.

(4) Up to 90% guarantee.

(5) Maturity up to 20 years on real estate acquisition and construction - up to 10 years on all others.

B. 7(i) Economic Opportunity Loan Program

(1) Direct, immediate participation, and guaranty loans limited to $100,000.

(2) Direct and immediate participation interest rate determined by statutory formula which sets a minimum rate (different from 7(a) presently 7-1/4%.

(3) Up to 100% guarantee.

(4) All loans may have maturities up to 15 years.

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C. 7(h) Handicapped Assistance Loan Program

(1) Direct, immediate participation and guaranty loans up to $350,000.

(2) Interest rate statutorily set at 3%.

(3) Up to 100% guarantee.

(4) All loans may have maturities up to 15 years.

D. Section 501 Loans

(1) No limit on size except that loans may not exceed development company's total borrowings from all other sources.

(2) Interest rate fixed by Administrator presently 6-5/8%.

(3) No statutory limit on maturities.

E. Section 502 Loans

(1) Direct, immediate participation and guaranty loans up to $500,000.

(2) Interest rate fixed by Administrator - presently 6-5/8%.

(3) Guaranty up to 90%.

(4) All loans may have maturities up to 25 years.

F. Non-Physical Disaster Loans

(a) 7(b)(9) Economic Dislocation Loans

(1) Direct, immediate participation, and guaranty loans limited to $100,000.

(2) Interest rate statutorily set at 3%.

(3) Guarantee up to 90%.

(4) Maturity up to 30 years.

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(b) All Other Non-Physical Disaster Loans -

7(b)(2), 7(b)(3), 7(b)(4), 7(b)(5), 7(b)(6), 7(b)(7), 7(b)(8), 7(g)(1).

(1) Unlimited as to amount.

(2) Interest rate set by statutory formula which sets a maximum rate - presently 6/5/8%.

(3) Up to 90% guarantee.

(4) Maturity up to 30 years.

Other features of the various loan programs are brought out in the attached schedule of loan programs.

We feel that our potential for impact on the small business community will be much more significant if our programs were consolidated, thereby eliminating confusion in both the small business and banking communities as to what assistance is available, the extent thereof and under what terms.

Consolidation of loan programs is an effort to bring together those programs that are so similar in nature as to not warrant seperate and specific mention or authorization in the statute. It is not, in any way, an attempt to de-emphasize any of our present efforts. Rather, combining the programs will give us the flexibility to give priority to our efforts and enable us to set or modify goals in order to accomplish specific objectives as may be determined necessary or desirable by Congress and the Administration. For instance, funds are presently allocated for each separate program, e.g., EOL, HAL, 7(a), and 502. If Congress or the Administration felt it necessary that we increase our efforts in a given program area, or if demand unexpectedly increased, we could conceivably run short of funds in that category. In such a case, in the absence of additional appropriations, we would be unable to make loans in one category while activity would continue in the others.

The proposed consolidation would also enable us to shorten and simplify our Regulations, consolidate and/or eliminate several SOP's. Too much time is spent by both professional and quasi-technical personnel attempting to determine which program criteria apply to loans as they are received and processed. Consolidation would speed up the Agency's delivery of assistance.

We have developed three possible alternatives which are attached.

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COMMENTS ON PROPOSAL "C"

- Proposal is identical to "B" except that the "socially oriented" loans, EOL and HAL, would be separated into the fourth category, 7(d).
- The fourth category would make these two programs more visible, thus this proposal may have political appeal.
- EOL and HAL loans are simply business loans, vis-a-vis physical or economic disaster loans to business, so could be accommodated in 7(a) with appropriate language.
- All other comments in Proposal "B" are applicable to this proposal.

Proposal "C" is our third choice.

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APPENDIX IV

LOAN AND MATURITY LEVELS

In order to provide job creating potential to the fullest extent, SBA's guaranty loan levels should be raised by elgislation to $750,000 - $1 million with maturities not to exceed 30 years.

For specific "job creating" loan requests to be made under very closely controlled criteria, it is recommended that there be no legal lending limit - as is the case in the Department of Agriculture's Business and Industry Loan Program.

Pursuant to P. L. 94-305 (6/4/76), SBA's loan levels were raised from $350,000 to $500,000. Maturity remained at 10 years (20 years for acquiring real property or construction of facilities).

GUARANTY LOAN LEVELS

The SBA statutory limits on business loans were adjusted by use of the GNP implicit price deflator. From 1953 and 1958 to the second quarter of 1977 the increase in the price index was as follows:

$\frac{2Q1977}{1953} = \frac{140.51}{58.88}$ = 238.6 percent change or 138.6 percent increase

$\frac{2Q1977}{1958} = \frac{140.51}{66.06}$ = 212.7 percent change or 112.7 percent increase

The loan level was $250,000 in 1953, $350,000 in 1958 and $500,000 in 1977 for regular SBA guaranty loans.

1953 $250,000 x 2.386 = $596,500
1958 $350,000 x 2.127 = $744,450

The above calculations support the contention that the guaranty loan level could (and perhaps should) have been raised to $750,000 rather than $500,000 in mid 1976.

Further support can be obtained through an analysis of Sales, Assets and Employment data for the fortune 500 industrials. The fortune 500 data were not published for 1953 but figures for 1955, the first year, 1958, and 1977 are shown below. Sales, of course, represent the cumulative data for the preceeding year.

Fortune Issue	Sales ($000)	Assets ($000)	Employment
July 1955 Total	$136,782,913	107,868,512	7,857,483
Av. per employee	17,408	13,728	
July 1958 Total	188,312,743	148,807,184	9,078,606
Av. per employee	20,742	16,391	

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May 1977 Total	971,133,210	736,836,823	14,836,163
Av. per employee	65,457	49,665	
Percent of Change 1977/1955	710.0%	683.1%	188.8%
Percent of Change 1977/1958	515.7%	495.2%	163.4%

Our most significant job creating type of small business is obviously manufacturing. An analysis of SBA's portfolio for the last three fiscal years reflects the following percentages:

	% OF TOTAL APPROVALS	
	NUMBERS	DOLLARS
FY 1975	15.7	25.7
FY 1976	14.2	22.2
FY 1976 (Transition quarter)	13.5	20.8
FY 1977	13.9	21.3
Total	14.5%	22.5%

It is opined that SBA's past and present loan levels are not sufficient to accommodate the borrowed capital needs of most small manufacturing concerns across the country.

MATURITY

The recommendation to raise the maturity for guaranty loans to a maximum of 30 years is based mainly on the Agency's excellent experience with Local Development Company Loans (502) which has a maturity of up to 25 years, plus construction time.

The purpose of 502 loans involves plant acquisition, construction, conversion, expansion, including acquiring land and fixed M/E.

In addition, we seek to bring the Agency's programs in line with FmHA's Business and Industry program and to finally recognize the longer conventional terms that are existent in today's economy.

The very nature of the above uses of loan proceeds are closely tied to economic stimulus (job creation).

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Appendix V

A VIABLE SECONDARY MARKET

As currently operated the secondary market is overly fragmented. The cumbersome nature of the present transfer system effectively reduces the free movement of the investments in the market place. It is, therefore, difficult to obtain accurate and adequate information on pricing, yields and activity.

These elements have had a limiting effect on the growth of the secondary market. To support future increases in guaranty loan activity, it is essential that a highly developed and smoothly functioning secondary market be available.

To make the improvements required SBA is in the process of negotiation with a private firm to perform a centralized transfer and paying system and concurrently is developing a certificate of ownership which can be freely traded. The transfer and paying agent will function as a centralized system to make settlements of initial sales entered into by lenders and investors. Subsequent to the initial sale it will bill, collect and disburse the payments on each loan. A lender with several loans sold would receive a single bill with all particulars and make one payment each period. An investor with several loans purchased would receive one check with all particulars on the loans reported. Sales on the secondary market would involve the issuance of new certificates and cancellations of old.

This opportunity for liquidity and the ability to purchase packages of loans in large dollar amounts will attract new and larger investors. Yields to investors are expected to fall, creating greater inducement to lenders making greater amounts of funds available to small businesses. Eventually, rates paid by small businesses should be reduced.

Formal proposals are expected by November 15, 1977; selection of the agent by December 15, 1977, and initial operation by February 1, 1978.

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A SURVEY OF SMALL BUSINESS ADMINISTRATION BUSINESS BORROWERS FOR FISCAL YEAR ENDING JUNE 30, 1976

INTRODUCTION

In June 1977 the Administrator of the Small Business Administration designated a reorganization study team to consider methods of making SBA more responsive to the needs of the small business community and to bring its programs in accord with the mandates of the Congress and the priorities of the President. One of the early projects of the Task Force on Reorganization was to conduct a survey of SBA business loan borrowers for the purpose of determining the impact of the business loans on employment of borrowers and potential of the loan programs as a private sector vehicle for job creation. This first attempt to measure the SBA loan employment impact resulted in the following findings:

> An average of $10,000 in loans created one job and maintained approximately three jobs.
>
> Depending on the employment impact of factors other than the SBA loan, the average loan dollars required for each new job reasonably could range from $10,000 to $22,000.

Although SBA management discussed the job creation study within the Executive Branch, the Agency took no official position on the findings and in general the data were considered to be suspect. Numerous questions were raised concerning the sample design and survey procedures. In March 1978 Congressman Breckinridge asked the SBA Assistant Administrator for Planning, Research and Data Management to resolve these problems and to provide him with final estimates of the job creation impact of the business loan programs.

The SBA review of the technical aspects of the survey has been thorough. It has included an extensive telephone followup to

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increase the response rate and to improve the quality of reported data. The response rate for the survey is considered to be excellent, and although various problems with both the survey data and loan data in the SBA files remain, the quality of the survey statistics have been improved to the extent possible. The size of the sample proved to be more than adequate for specified requirements of the survey. Finally, the reliability of the sample design and estimating procedure was tested by using the survey as a vehicle to estimate the total value of SBA business loans approved during Fiscal Year 1976 for comparison with the true value from SBA accounting records. The relationship was very satisfactory. On the basis of the survey review the findings have been revised as follows:

> An average of $20,000 in loans created one job.
>
> Depending on the employment impact of factors other than the SBA loan, the average loan dollars required for each new job reasonably could increase from $20,000 to $29,000.

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A SURVEY OF SMALL BUSINESS ADMINISTRATION BUSINESS BORROWERS FOR FISCAL YEAR ENDING JUNE 30, 1976

Introduction

The Carter/Mondale SBA Transition Planning Group had recommended that SBA become involved in the Administration's economic stimulus program as a vehicle for job creation because (1) small business is relatively labor intensive and can contribute effectively to Government goals for employment, (2) SBA programs would involve the private sector from the standpoint of both the lender and the borrower with a minimum impact on the Federal budget, and (3) the result of a private sector employment effort generally is of a longer duration than that of the public job creation program.

Purpose of the Survey. To determine the impact of SBA business loans on the employment of its borrowers became a principal project of the SBA Task Force on Reorganization at the time it was organized on June 23, 1977. It was the intent of the Task Force to establish a cost-benefit basis for matching the SBA loan programs with other Federal plans to increase employment. The Task Force determined that the sample survey provided the most efficient and economical method to develop the required information. To the extent possible the standards for this survey were to follow the established and published uniform practices of the Office of Federal Statistical Policy and Standards, U.S. Department of Commerce (formerly OMB).[1] The following sections on the development and findings of the survey

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are discussed within the framework of these prescribed guidelines.

Review of Related Materials

Before determining the techniques for measuring the employment impact of SBA business loans, the Task Force reviewed related work of the Agency and of Government and private groups. The latter included works of the Congressional Budget Office and papers on job creation by the private sector which were presented at The Brookings Institution in May 1977. Some of these materials were of a theoretical nature and did not provide statistical estimates of employment impact. For those which did provide such detail the Task Force was unable to obtain information on the specific details on the methodology which was used. Task Force members also spoke with personnel of the Department of Treasury about their evaluation of the business investment tax credits and other business tax cuts. Treasury had not estimated the economic or employment impact of these measures.

Previous job creation data of the Small Business Administration also was reviewed. Over time the data generated within SBA on job creation have represented a combination of employment figures for existing and new firms as reported on SBA Form 135, Loan Approval Document (Appendix I). On Form 135 existing firms report the number of employees on the payroll nearest the loan approval date, but new firms enter employment which they expect to materialize as a result of the loan. The combination of these figures has been described by SBA as jobs created and maintained. These figures were unsuitable for establishing a cost/benefit base because job creation could not

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be segregated from job maintenance and the entire employment at the time the loan was made was attributed to the impact of the SBA action. No information was available on employment change of a firm after a loan was approved.

Selection of the Criterion of Job Creation

Survey Focus. The focus of the Survey of SBA Business Borrowers was on employment change after the loan was made or on so-called job creation. This information was to be used as the base for cost/benefit estimates. Although the respondent was asked how many persons continued to have jobs because the firm received a loan, estimates of jobs maintained were of secondary importance to the Task Force report.

The Task Force selected the year following approval of the loan as the period of time for measurement of employment change. Established firms were to report employment on their payrolls nearest the date of loan approval, and firms established as a result of the loan were to record their beginning employment as zero (Questionnaire and reporting instructions - Appendix II). In all instances the employment figures were the accounting figures of the respondents.

Other Considerations. In the opinion of the Task Force, the principal criticism of employment change as the criterion of job creation would result from the possibility that it could overstate the number of jobs resulting solely from the effect of the SBA business loan. Some portion of a positive employment change could result from any or all of the following types of conditions:

1. Favorable economic conditions of a national, regional, local or industry nature,

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2. Availability of credit or capital from sources other than the Small Business Administration, and

3. Shifts of new employees from payrolls of other firms.

The deliberations and decisions of the Task Force on these particular modifications are summarized in Appendix III, Factors Affecting Job Creation. Other factors could be cited as possible causes of employment change, but the segregation and measurement of their effects would be similar to the procedures outlined in the Appendix.

Conclusions on the Criterion. After review of information on measurement of employment and budget impact of public and private sector programs, the Task Force drew the following conclusions concerning the criterion of job creation:

1. For estimating purposes, change in employment is preferable to alternative measures. Reported information can be verified from accounting records. The question can be precisely defined and is easily understood by respondents, and the period of time under consideration can be firmly established.

2. From a survey standpoint, the only practical alternative would be to ask an opinion question such as, "How many persons did you hire as the result of your SBA loan?" or "How many jobs did your SBA loan create?" SBA could not hope to have respondents contribute portions of employment increases to various causes. Even answers to a single opinion question would be difficult to evaluate. For example, if the respondent used the loan for building inventories and at the same time expanded his sales staff, would he credit the employment increase to the loan?

3. As SBA is a lender of last resort, its employment impact should be interpreted more generally than the impact of regular bank loans. Availability of the Government guarantee often will trigger other sources of financing which otherwise would not be forthcoming. (The opinions of

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some SBA borrowers that they could have obtained financing without SBA participation or guarantee is no more reliable than the statements of the corresponding bankers that they could not.)

4. Shifts of employees from payrolls to SBA borrowers is a very significant factor in evaluating the job creation impact of the loan programs. Adjustments for employment shifts were to be made to the findings of the survey on the basis of estimates of the proportion of jobs filled from the ranks of the unemployed.[2]

5. Adjustments for changes in the business cycle also would have to be made to the survey findings--not incorporated into the survey procedure, but they could not be developed for the initial report in the time period allotted for the Task Force work.

6. Measurement of the employment impact of other selected private sector programs are equally as questionable as the measurement of the impact of the SBA business loan programs. Some of these incentives--particularly the business tax cuts--incorporate the same disadvantages as job creation vehicles, but both have the long-run advantage of using and promoting private sector participation.[3]

Development of the Survey

The two following requirements of the Task Force dictated the use of a small sample and efficient survey procedures:

1. To support the Administration's policy to keep the paperwork burden imposed on the public to a minimum, and

2. To produce at least preliminary findings from the survey by late summer or early fall of 1977 for discussion within the Executive Office.

The design of the sample, the questionnaire, and the method of data collection were tailored to provide an administratively feasible operation and maximum precision of results in a short period of time, and with the resources immediately available. In lieu of pretesting to produce such information as estimates of variance for sample design,

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probable nonresponse rates and relative effectiveness of different questionnaire procedures, the Task Force made maximum use of existing related information and sought expert assistance in the design and conduct of the survey. Data used for developing the sample size were tabulated from the computer records of SBA borrowers during Fiscal Year 1976. Procedures which had been used for the collection and appraisal of data in three other major surveys of either Small Business Administration clientele or small firms were reviewed for their apparent strengths and weaknesses. The assistance of a statistician of the Bureau of the Census who was trained and experienced in sampling theory and conduct of surveys was obtained on an informal basis. He designed the sample and prepared estimating and processing procedures for the survey. The survey objectives and the desired precision of the findings, the survey time period, and the collection procedure were decided by the Task Force.

The Sample. The sample was drawn from the 26,006 business loan approvals for Fiscal Year 1976.[4] FY 1976 was chosen as the sampling time period because its economic environment was similar to that of the recent past, and the time span would permit each borrower to report on a full year of change after approval of the SBA business loan.[5] The sample was keyed to employment and designed to estimate the proportion of change in employment, sales, and payroll.[6]

The sample was stratified on employee size with simple random sampling within the six noncertainty categories of less than 100 employees. All cases in employment categories of 100 or more persons were included in the sample. The total sample contained 441 cases--

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308 with 100 or more employees and 133 from the remaining 25,698 establishments with 99 or fewer employees. The Neyman allocation results were used to obtain the noncertainty sample sizes.[7]

Selection of all elements in the largest sample strata was an acceptable sampling procedure[8] and a logical and efficient method for dealing with the problem at hand. The statistician for Computer Sciences Corporation who directed the tabulation of the survey returns commented on the stratification of the sample as follows:

> . . . the stratification ought to identify the largest numbers of employees affected, not sample the largest number of firms. When the class mark ("average" number of employees in a firm in a stratum) times the number of firms in the stratum is calculated for each stratum, one sees that the certainty stratum represents approximately 62,000 employees while the rest of the six noncertainty strata represent approximately 230,000. Thus, one percent of the firms employed 21% of /the/ workers. It is quite reasonable to sample this comparatively small number of firms completely and sample the much more sparsely populated other strata. In addition, only sampling this largest stratum will likely increase the variance and decrease the precision of global estimates, hence, completely sampling is a very efficient means of reducing doubt about the estimates derived from the survey.[9]

The same statistician also remarked on the selection of employment as the variable of stratification as cited below:

> . . . The decision to use employment as the variable of stratification, rather than dollar amount of loan came from a consideration of what was desired. Stratifying on dollar amount requires the additional assumption that employment and amount of loan are highly correlated. Actually as can be seen from the data quite large loans were taken to begin businesses from scratch, hence the correlation could not be assumed high.[10]

Reliability and Precision of Sample. The Task Force survey was the first effort to measure the proportion of change in employment

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which had resulted from the business loan program, and Task Force members estimated that the ratio would not be less than 10 percent and probably would be very much higher. A sample of 441 cases was selected to detect an employment change of 10 percent (P) from just prior to the date of loan approval to a year after that date with a 95 percent confidence interval and relative error of (P) of ±10 percent. An assumption of a larger proportion of employment change with the same requirements of reliability and precision would not have called for as large a sample. The selected sample included provisions for handling partial and full nonresponse and data misclassified prior to sampling.

Survey Clearance. In late July 1977 the SBA Paperwork Management Branch submitted the questionnaire for the Job Creation Study including supporting statements on survey purpose, sample design, interviewing instructions and collection procedure to the Office of Management and Budget for clearance. In early August approval was received for use of the form, O.M.B. No. 100-S77003, through October 1977 (Appendix IV).

Method of Collection. The Task Force considered the use of a mailed survey but decided the nature of information requested and the short time period allotted for the project dictated selection of a telephone survey. A mail survey often results in substantial nonresponse and requires time-consuming followups. The simplicity of the information to be requested and short length of the questionnaire led the Task Force to believe the telephone methods would prove adequate. With respect to assets this judgment was incorrect.

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Borrowers could not readily answer the question on value of assets, and because of the poor response, it was eliminated from followup and processing. The response to inquiries on sales and payroll was satisfactory, but limitations imposed on the amount of detail which could be incorporated into the questionnaire and the elimination of these items from the stratification scheme of the sample design tended to create bias in the estimates. Therefore, the Task Force used the sales and payroll data principally as checks for reasonableness with employment and published statistics on income and taxes for purposes of cost/benefit analysis.

Preliminary Survey Findings

Mid-October was the deadline set for development of job creation data for use in the report on the SBA business loan program as an economic stimulus vehicle. By that time editing of returns and the most essential telephone followups had been completed for 335 respondents to the questionnaire or 75 percent of the cases. However, with their available resources the Task Force could not complete estimating procedures for the Fiscal Year 1976 borrower universe by the deadline. As an alternative the members elected to use the average loan approval value of the reported cases as a basis for estimating job creation impact of a $1 billion business loan program. It was assumed that the overall industry composition and loan requirements of the additional borrowers would be reasonably similar to the composition and needs of borrowers of the $2 billion of loans during Fiscal Year 1976. The Task Force realized that substitution of judgmental factors for probability theory would create an immeasurable amount of bias in

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results and implemented the following adjustments to limit upward thrust on the job creation estimates:

1. Declines in employment were viewed as "negative" creation and deducted from creation.

2. Only 6 of every 10 jobs were counted as being drawn from the unemployed ranks.

3. Job creation was reduced another 15,000 cases to adjust for upward biases which might be created by the estimating procedure.

The job creation impact of the $1 billion loan package, therefore, ranged from a high of 100,000 to a low of 45,000 employees with corresponding values of loan approvals of $10,000 to $22,000. At either extreme the estimates strongly suggested that SBA borrowers experienced significant employment change and the input of Agency guaranteed and direct loan dollars was very reasonable. In addition to the creation of a new job, each $10,000 in loans maintained approximately three jobs.

Final Survey Results

The initial survey estimates raised numerous questions among readers of the job creation report concerning sample design, survey procedures and assumptions. In March at the hearing on the Future of Small Business in America before the House Small Business Subcommittee on Antitrust, Consumer and Employment, Congressman John Breckinridge asked the SBA Assistant Administrator for Planning, Research and Data Management to resolve these problems and to report to him on the revised findings of the survey.

As a result of Mr. Breckinridge's request, the technical aspects of the survey have been totally reviewed. Numerous telephone calls

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were made to increase the survey response rate and to resolve differences between data items on the questionnaire and between the borrower's employment in SBA loan records and reported on the survey. Five cases were eliminated from the survey because of multiple loans to a single borrower for timber purchases. The remaining 436 cases were distributed by processing categories as follows:

Category	Percent
Total	100
Response	80
Cancellations	13
Out-of-business and paid up	6
Nonresponses	1

The work of handling sample estimating procedures was contracted to Computer Science Corporation where it was developed and supervised by a statistician. Estimates for the Fiscal Year 1976 universe of business loan borrowers were completed. As a test of the effectiveness of the sample, the estimating procedure included the total value of business loans approved during Fiscal Year 1976 which could be checked against the true value of the Agency's accounting records. The survey estimate was remarkedly close to the true value. It was $2,076 million as compared with a total of $2,065 million in SBA loan approvals as of June 30, 1976. This check is considered to be a strong defense of the validity of the sample design and estimating procedure which had been developed for the survey.

Survey Estimates. The proportion of change in employment which was derived from the survey was 57.8 percent with a standard error of ±12.9 percent and ±25.8 percent within the 95 percent

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confidence interval of two standard deviations.[11] In determining the sample size the Task Force had selected an employment change of 10 percent (P) with a 95 percent confidence interval and a relative error of (P) of ±10 percent. In their defense against obtaining a ratio of less than 10 percent, the Task Force used a sample size which exceeded the requirements of their specifications for the survey results.

The employment increase for the universe of business loan borrowers was 101,845 and the estimated value of loans approved was $2.08 billion which gives a revised value of loans per job created of approximately $20,000. This estimate is only 9 percent below the lower range of loan approval value per job created ($22,000) of the preliminary Task Force estimates. A total of 126,490 employees maintained their jobs as a result of SBA loan approvals, and the total jobs created and maintained was 228,335 with an average loan value of approximately $9,100.

Further adjustment of the job creation estimate for shifts of employees from payrolls of other firms now should be based on a revised statement that 7 in 10 workers (instead of 6) come from the ranks of the unemployed. As the survey estimating procedure has been completed, it no longer is necessary to adjust for the bias created by using only data for the 335 initial respondents to the survey questionnaire. Using the new unemployment estimator, the 101,845 jobs created would be reduced to roughly 71,000, with an average loan approval value per job of about $29,000. The new range for loan dollars per new job would be $20,000 to $29,000, instead of $10,000 to $22,000, as

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given in the preliminary report.

Criticisms of Preliminary Data. The review of the sample design and development of the estimating procedures have satisfied many of the criticisms of the preliminary findings. These criticisms and corresponding comments are summarized in Appendix V.

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Footnotes

[1]U.S. Department of Commerce, Office of Federal Statistical Policy and Standards, Statistical Policy Handbook (Washington, D.C.: U.S. Government Printing Office, 1978), pp. 5-10. (Although the reference was not published until 1978, the guidelines were available in 1977.)

[2]Congress of the United States, Congressional Budget Office, Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives (Washington, D.C., September 2, 1975), p. 4. (More recently the estimate of the proportion of jobs filled by unemployed persons was revised upward. SBA chose to use the earlier and less favorable measure.)

[3]Ibid., pp. iii-xii and 51-75. (Since 1975 the CBO has revised its estimating methodology but similar detail for the various public and private sector programs was not available to SBA.)

[4]The 26,006 business loan approvals was the number in the computer record as of July 28, 1977.

[5]The Task Force considered the advantages of using a first disbursement date, but decided the mere approval of an SBA loan often generated accompanying types of financing such as trade credit, and the loan approval date was pertinent to changes in employment.

[6]William G. Cochran, Sampling Techniques, 2nd Edition (New York: John Wiley & Sons, 1963), pp. 169-175.

[7]Ibid., pp. 127-131.

[8]Selection of all elements in the largest stratum is discussed in the following texts on sampling theory: Morris H. Hansen, William N. Hurwitz and William G. Madow, Sample Survey Methods and Theory, Volume I (New York: John Wiley & Sons, 1966), p. 582 and Seymour Sudman, Applied Sampling (New York: Academic Press, 1976), pp. 115 and 117.

[9]Computer Science Corporation, "Critique," (Unpublished comments of statistician).

[10]Computer Science Corporation, "SBA Employment Change Survey," July 7, 1978, (Unpublished comments of statistician).

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[11]The levels and corresponding confidence intervals for employment change are as follows:

	Total Employment		Employment Change	
	Before Loan Approval	Year After Loan Approval	Level	Confidence Interval (95%)
Employment				
Number	176,351	278,197	101,845	95,223-108,467
Percent	100.0	157.8	57.8	32-84

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APPENDIX II

INSTRUCTION TO INTERVIEWER
ON
SAMPLE SURVEY OF SBA BUSINESS BORROWERS FOR FISCAL YEAR ENDING JUNE 30, 1976

The purpose of the attached questionnaire is to obtain information on the benefits which borrowers derived from SBA loans during the first year after the loan was approved. This information will be used to approximate the ripple effect of benefits to the Federal Government and to develop cost-benefit information to match with benefits of alternative Federal financing programs. SPEAK TO AN OWNER, MANAGER

1. The questionnaire relates only to the business entity which was identified on SBA Form 135, Loan Approval Document, as the borrower.

2. Interviews should be conducted by telephone. If this cannot be done, the interviewer may make an appointment for a personal interview at the mutual convenience of the interviewer and respondent.

3. If a business selected in the sample could not be interviewed, state the reason why the interview was not completed and return the questionnaire.

4. Column (A) of the questionnaire, Prior to the Loan, means prior to the approval date of the loan. As many borrowers are very small firms, they probably can answer the questionnaire without referring to accounting records. However, if the interviewer specifies the period of time, it should be the most recent payroll or accounting period before the loan was approved.
   Column (B) of the questionnaire refers to one-year after the first date. If a firm went out of business, zero should be recorded in Column (B). If the firm was sold, the last figures for the operation should be recorded even though they may not represent a full year of activity after loan approval.

5. If the business was established as a result of receiving the SBA loan, enter "0" in Column (A), Prior to the Loan. Do not enter the number of persons which the borrower expected to employ or the value of assets which was expected to materialize from the loan.

6. If the business was operating at the time of loan approval, the number of employees in Column (A), Prior to the Loan, must be at least "1" because the count includes proprietors and owners of unincorporated firms, their unpaid family workers, and temporary and part-time workers. Part-time workers should be averaged out and recorded in the count as full-time equivalents. For example, five part-time employees would be recorded as two employees. In the case of a corporation include salaried officers, executives, their staff and persons on vacation and sick leave who received pay for the pay period. Do not include persons on leave-without-pay and pensioners.

7. If additional information is required, call (202) 653-6598 - Cullen. Kal Skeirik is Cullen's alternate from 8/5-8/29 653-6593

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